Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations

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Effective date July 1997 Section 1000.1

The Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations was prepared under the direction of the Federal Reserve Board and Reserve Bank supervision personnel. Federal Reserve staff acknowledge and thank the staff of the New York State Banking Department, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Conference of State Bank Supervisors for contributing to the devel-

opment of the manual. Accordingly, this manual reflects general policies and procedures to be used in conducting examinations of individual branches and agencies of foreign banking organizations.

The manual will be updated periodically to reflect changes in examination policies and procedures. We solicit the input and contribution of all supervisory staff and others in the refining and modification of its contents.

Effective date July 1997

Foreign banking organizations have had a longstanding presence in the United States. Their operations encompass a wide variety of banking and nonbanking activities, through subsidiaries, branches, agencies, and representative offices. These activities are located primarily in the major U.S. cities where finance and international trade are most actively conducted.

Branches of foreign banking organizations are licensed by the state banking authorities or the Office of the Comptroller of the Currency. In addition, certain grandfathered branches may be insured by the Federal Deposit Insurance Corporation. Agencies are licensed by the state banking authorities. The Federal Reserve, therefore, shares its regulatory responsibility with other state and federal supervisory authorities. Separately, the Board of Governors delegates certain of its supervisory and regulatory functions to the Reserve Banks and directs, coordinates, and reviews actions taken by the Reserve Banks.

Prior to the December 1991 passage of the Foreign Bank Supervision Enhancement Act (FBSEA), the examination of federal and state branches and agencies of foreign banks was largely the responsibility of the respective licensing authorities (the states and the OCC). The

International Banking Act of 1978 instructed the Federal Reserve to use, to the extent possible, the examination reports of other state and federal regulators in carrying out its responsibility for overseeing the U.S. operations of foreign banking organizations. Enactment of FBSEA was intended to fill gaps in the supervision and regulation of the U.S. operations of foreign banks and to ensure that the banking policies established by Congress are implemented in a fair and consistent manner with respect to all entities (domestic and foreign) conducting a banking business in the United States. FBSEA established uniform federal standards for entry and expansion of foreign banks in the United States and substantially increased the role of the Federal Reserve in the supervision and regulation of their U.S. activities. Under FBSEA, the Federal Reserve may examine any office or affiliate of a foreign bank in the United States and is to coordinate such examinations with the OCC, FDIC, and appropriate state banking supervisors to the extent possible. A comprehensive set of procedures has been developed to provide a uniform framework to be used in examining branches and agencies of foreign banking organizations.

FORMAT

This manual is divided into sections dealing with particular banking activities that relate specifically to the examination and evaluation of U.S. branches and agencies¹ of foreign banking organizations (FBOs). Each section, in turn, may be divided into up to five subsections, depending upon the topic of discussion. These subsections are:

- · Overview.
- Examination Objectives.
- · Examination Procedures.
- · Internal Control Questionnaire.
- · Audit Guidelines.

The manual is intended to provide a comprehensive overview of banking activities that may be conducted in a wide variety of branches. Not all activities will be conducted by every branch. Accordingly, the examiner-in-charge should plan the examination, particularly as it relates to examination procedures and internal control questionnaires, based on the range of activities of the particular branch under examination. (This point is discussed in greater detail below.)

Overview

The Overview section presents background information on the respective topics. This information will be supplemented and reinforced through the supervisory agencies' educational programs, updates to existing supervisory policies, and the examiner's growing on-the-job experience.

Examination Objectives

The subsections in the Examination Objectives section list the goals that should be of primary interest to the examiner. Examination objectives are broadly stated and are thus similar for most manual sections. The objectives directly relate to procedures that will be performed at the examination and thus will influence the scope of the examination for the specific focus of examination interest.

In general, key examination objectives are designed to determine how well risk is managed by: (1) determining the adequacy of the system of internal control and of policies, practices, and procedures; (2) evaluating the scope and adequacy of the internal control environment and audit function; (3) determining compliance with laws, regulations, and rulings; and (4) evaluating adherence with internal policies and procedures. These objectives all relate to the overall assessment of the branch as described in the ROCA rating system and ultimately could result in the implementation of corrective action, if appropriate.

Examination Procedures

These subsections include procedures to be performed during a comprehensive examination of the particular area of examination interest. There may be instances where the procedures will not apply in their entirety to a particular branch; thus, the examiner-in-charge should exercise judgement as to which procedures will be conducted during the on-site examination. The procedures to be addressed should be based upon the particular characteristics of the branch under examination, such as size, range, and complexity of activities and condition. The materiality and significance of a given area of a branch's operations are primary considerations in determining the scope of the examination and the procedures to be performed. Examiner flexibility in this respect will result in examinations that are tailored to fit the condition, nature, and scope of operations, i.e., a risk focus approach.

If, for example, serious deficiencies surface or issues are raised during an examination, all relevant examination procedures set forth in the manual are generally expected to be followed. Additional procedures may also be required from other supervisory manuals and materials. When modifying the procedures, the examiner-in-charge is responsible for determining that the examination objectives are met and that the scope of the examination is consistent with the condition of the individual branch.

Internal Control Questionnaire

The evaluation of a branch's internal control environment should encompass a review of the

^{1.} Collectively referred to as "branches" throughout this manual, unless otherwise indicated.

internal audit activities and the implementation of selected Internal Control Questionnaires (ICQs), which set forth standards for operational control. Due to the inherent differences between an examination and an audit, it is not contemplated that all ICQs will necessarily be implemented on every examination. The ICQs employed during the course of the examination should include: (1) those selected by the examiner-in-charge based upon his/her experience, knowledge of problems within the branch, and perception of risk; and (2) those that focus on areas where on-site evaluation of operational control seems warranted in light of the results of the examination of internal audit activities. In addition to serving as a guide for on-site evaluations, the ICQs can be used in the appraisal of operational audit techniques.

Audit Guidelines

The Audit Guidelines under selected sections are included as an additional source of information relative to special situations where serious issues are raised with respect to the internal audit program or the general internal control environment. Audit Guidelines set forth traditional audit techniques that ideally should be employed by the local staff, head office, internal or external auditors, or a combination thereof. Audit guidelines should not be routinely included in the scope of every examination.

NUMBERING SYSTEM

The manual is arranged using a numbering system based on the manual's sections and subsections. For example, the Overview subsection of the Credit Risk Management section is numbered 3010.1., 3010 is the section number for Credit Risk Management, and .1 is the subsection number for the Overview. The Examination Objectives subsection for that section is numbered 3010.2, and so on. Subsections are always numbered consecutively regardless of the number of subsections within a particular section.

The manual was initially published in January 1995, and subsequently revised July 1997. Since the entire manual was updated and reprinted at that time, all pages are dated as of the July 1997 revision date. Supplemental pages will be periodically published and distributed by the Federal Reserve Board and appropriately dated.

USE OF MANUAL

The manual should serve as a working tool as well as a reference manual. It is organized to provide flexibility to the examiner in planning and conducting a branch examination and identifying the key areas of concern as presented in the ROCA rating system.

As discussed earlier, examination procedures may be modified, depending upon the size, range of activities, and condition of the branch. State laws and local characteristics may also necessitate a review of additional factors and supplemental procedures. For example, specific procedures relating to highly sophisticated trading activities have not been included in this manual. Examination procedures for those activities may be found in the Trading Activities Manual of the Board of Governors of the Federal Reserve System. Similarly, applicable State, FDIC, and OCC banking rules and regulations must be considered in various areas, such as those relating to asset maintenance requirements or asset pledge/capital equivalency deposits.

Although the manual discusses selected branch activities in general terms, it is primarily oriented toward describing examination procedures covering those activities. Therefore, the manual should not be viewed as a comprehensive training guide or a legal reference. Separate training programs will provide more detailed instructions to assist the examiner in better understanding branch activities and applying examination procedures. In addition, questions concerning applicability and compliance with federal and state laws and regulations should be referred to the legal staff of the appropriate regulatory agency.

Enhanced Framework for Supervising the U.S. Operations of Foreign Banking Organizations

Effective date July 1997

Section 2000.1

Foreign banking organizations ("FBOs") conduct an extensive and diverse business in the United States. Consistent with economic efficiency and national treatment, FBOs are free to conduct their U.S. activities through a variety of legal entities. Banking activities are conducted primarily through branches or agencies licensed by the individual states or by the Comptroller of the Currency and, to a lesser extent, through banks chartered by those banking supervisory authorities and through special-purpose banking corporations chartered by the states and the Federal Reserve. Some of these banking entities also are insured and therefore subject to the oversight of the Federal Deposit Insurance Corporation. Non-banking activities are authorized by the Federal Reserve pursuant to the Bank Holding Company Act and the International Banking Act. In addition, the Federal Reserve shares supervisory responsibility with other regulatory agencies for FBOs with respect to the business they conduct within the United States, including representative offices. As a result, FBOs are subject to a number of state and federal statutes, and various aspects of their operations are supervised and regulated by both state and federal banking supervisory authorities.

In order to better coordinate and further enhance the supervision of the U.S. activities of FBOs, the banking supervisory authorities that have supervisory and examination powers over the U.S. operations of FBOs have developed a program encompassing the supervisory principles and processes relating to FBOs, which is summarized in the following sections.

Strength-of-Support Assessment for Foreign Banking Organizations with U.S. Operations

Effective date July 1997 Section 2001.1

OVERVIEW

The strength-of-support assessment (SOSA) provides a general framework for evaluating and assimilating significant financial and managerial information related to individual foreign banking organizations (FBOs) in order to assign a two-component SOSA. The FBO assessment provides information to the supervisory agencies that is taken into account in reaching decisions regarding the scope and frequency of examinations and other appropriate supervisory initiatives. The assessment also provides a basis for the more efficient utilization of supervisory resources.

The first component of the SOSA addresses whether any factors relating to the ability of the FBO to meet its U.S. obligations warrant special monitoring of the FBO's U.S. operations. This component is a reflection of the overall financial viability of the FBO as well as several external factors such as the degree of supervision the FBO receives from its home country supervisor. This component is based on a scale of "A" through "E" with "A" representing the lowest level of supervisory concern and "E" representing the highest.

Factors considered in assigning the first component include a review of the FBO's financial condition and prospects, the system of supervision in the FBO's home country, the record of home country government support of the banking system or other sources of support of the FBO, and any transfer risk concerns. In assigning this component, all relevant factors are weighed and evaluated. Standards and criteria for this component, including the five possible strength-of-support indicators, are discussed in greater detail below.

The second component of the SOSA, which is utilized on an as-needed basis, identifies whether there are any factors that raise questions about the ability of the FBO to maintain adequate internal controls and compliance procedures at its U.S. offices, irrespective of the overall financial condition of the FBO. If any such control risks are apparent, an asterisk is placed next to the letter component of the SOSA.

Factors considered in assigning the asterisk include the FBO's managerial and operational record and whether current activities such as a recent merger, significant other expansion or changes in operations, or reported control problems at non-U.S. operations pose a potential risk to the U.S. operations. The factors considered for this component also are discussed below. Specific standards or criteria for the second component of the SOSA are not discussed because the purpose of this component is to indicate whether any such concerns exist, a determination that is largely judgmental in nature and not readily quantified. For this reason, the asterisk is used rather than an alpha or numeric symbol which would incorrectly imply differing degrees of such concerns.

All SOSAs are for *internal supervisory use* only and are not disclosed to the general public or to FBO's management, either in the United States or at the head office or to the home country supervisor(s). If deemed appropriate, any specific concerns raised through the assessment process, rather than the assessment itself, will be communicated directly to the FBO's management and home country supervisor(s), particularly if those concerns lead to supervisory follow-up action with regard to the FBO's U.S. operations.

SOSA INDICATORS

There are five possible indicators for the first component of the SOSA:

Assessment of A—The FBO has a financial profile that is regarded as strong by both home country peer and international standards. It has superior risk-based capital ratios, more than ample access to U.S. dollar funding, and, if rated by any of the ratings agencies, is accorded one of the two highest market or investment rating categories. Supervision by the home country supervisory agency or agencies is conducted on a comprehensive basis, covering the worldwide

Risk-based capital ratios based on Basle or EC criteria are available for most banks. For those banks not providing such ratios, judgments related to the adequacy of capital are based on the ratio of equity capital to total assets.

operations of the FBO and its affiliates.² The home country has a good record of supervising financial institutions and dealing with problem institutions, and transfer risk is not an issue of concern. The FBO is an unquestioned source of strength to its U.S. operations.

Assessment of B—The financial profile and outlook pose a low risk that the FBO will be unable to support its U.S. operations. The FBO is viewed as investment grade or equivalent, capital ratios are above internationally accepted minima, and access to U.S. dollar funding is readily available; however, financial factors are not as strong as those of institutions with an assessment of A. The FBO is subject to a significant degree of supervision of its overall operations by the home country supervisor(s) and the country has a good record for dealing with problems in the local financial system. Transfer risk factors are generally consistent with those of FBOs with an assessment of A. An FBO whose financial profile is consistent with a B assessment could be assigned an assessment of C or lower if its home country has a supervisory system that is lacking in significant respects or significant transfer risk considerations exist.

Assessment of C—The current operating performance of the FBO and its immediate financial outlook, although not posing significant concerns about the ability of the organization to honor its U.S. liabilities, may warrant more than normal review based on such factors as the lack of an investment grade rating, capital ratios below internationally accepted minima, or other factors that are considered less than adequate by international standards. While the FBO currently may not meet all international financial standards, the home country has demonstrated an ability and willingness to support the FBO or similar financial institutions.

Conversely, the financial profile of the FBO may appear to warrant a stronger rating; however, supervision by the home country regulators is lacking in significant respects or significant transfer risk considerations exist.

Assessment of D—Significant financial or supervisory weaknesses are apparent such that imposition of asset maintenance requirements on the U.S. branches and agencies should be considered. The FBO may be expected to continue as a going concern due primarily to government support, ownership, or other significant factors, although resource constraints, transfer risk considerations, operating structure, or other factors may place important limitations on that support. Conversely, the financial profile, based on available information, may imply a higher assessment, but home country supervision is deemed to be substantially or wholly deficient, or there are significant transfer risk concerns.

Assessment of E—Due to a seriously deficient financial profile and/or poor operating practices and the absence of any sufficient supervisory oversight and support, there is a strong possibility that the FBO will be unable to honor its U.S. obligations in the near future or is otherwise considered to present a hazard to U.S. financial markets.

SOSA FACTORS

Determining whether an individual FBO has the internal or external resources to provide the necessary financial or managerial support to its U.S. operations depends to a great extent upon its financial condition, operating record, and general outlook. A good financial condition combined with capable management is generally sufficient to ensure that support. However, the degree of certainty about the ability of an FBO to provide any necessary financial support may be limited by weaknesses in its home country supervisory system or a significant degree of transfer risk associated with its major operations. These two factors also may influence the home country's record of support for its financial institutions.

Accordingly, the first component of the SOSA considers four major factors: (a) the financial profile of the FBO based on its present financial condition and outlook, including capital ratios and access to U.S. dollar liquidity; (b) the FBO's home country banking supervision system; (c) the demonstrated capabilities of the home country in dealing with banking problems; and (d) the degree of transfer risk associated with the FBO's home country and any other countries in which the FBO has major operations.

^{2.} This covers instances in which a determination regarding comprehensive, consolidated supervision has already been made by the Federal Reserve Board or where Board staff, based on available information, are prepared to make a positive recommendation to the Board with regard to comprehensive, consolidated supervision.

All assessment factors are considered as a whole in assigning the first component of the SOSA. None of the four principal factors are assigned a separate "rating" or are considered a discrete component of the final assessment.

Financial Profile

The financial profile of the FBO is based on the institution's current condition and future prospects. A review of financial condition is based on the level and trend in financial performance indicators relating to the FBO's capital, profitability and asset quality. These indicators should be evaluated in the context of peer performance and knowledge of the FBO's home country financial system and accounting policies and practices.³ The financial outlook should consider a broad range of external and internal factors, such as the home country banking system, the FBO's political and economic environment, its market position, risk profile, ownership, and management.

Generally, the FBO's short-term and longterm market ratings are good indicators of its financial outlook. An FBO with the highest market ratings should be able to demonstrate a strong financial condition and outlook. The FBO would likely be assigned an A assessment if other factors are consistent with the assessment. Notwithstanding the significance of market ratings, the FBO's financial profile and resultant assessment should not be based on market ratings alone. Rather the ratings should serve as a reference point for the independent assessment of the institution, because market ratings may not always reflect the most current view of the FBO or the supervisory authorities may have information not directly or indirectly available to the market. For example, examination findings of the U.S. operations could raise questions about the FBO's overall operations and management that could lead to a SOSA lower than that indicated by the FBO's market ratings. However, any significant difference between the assessment and market ratings should be fully analyzed and justified.

System of Home Country Supervision

A review of the home country supervisory system is essential to ensure that the FBO is subject to an appropriate level of supervision of its global operations. In assigning an FBO'S SOSA, the review of the system of home country supervision should concentrate on its general policies and how the supervisory framework applies in practice to the individual FBO. In this context, the mere presence of a home country supervisor is not considered sufficient.

The FBO's home country supervisory system should be evaluated based on those general principles and practices that ensure regulatory monitoring over the FBO's principal operations and activities, including those outside the home country. These general supervisory principles and practices usually include some level of periodic reporting, on-site and/or off-site review, prudential guidelines (including capital adequacy requirements), and supervisory enforcement powers. Effective regulatory systems may take many forms; however, the system of any country should ensure that the internationally active banks operating under that system are subject to a sufficient level of supervision.

Supervisory systems may also vary with respect to the type of institution. Therefore, the analysis of the supervisory system should evaluate actual regulatory practices for the individual FBO. This assessment will be based largely on the information that has been accumulated over time by the U.S. banking supervisory agencies. It is expected that this assessment will be enhanced as additional information on other supervisory systems is obtained through improved contacts and informational exchange.

Record of Home Country Support

Related to home country supervision is the matter of the home country's record of ensuring the solvency of its financial institutions, particularly those that operate internationally. The record of support varies by country with respect to structure, coverage of banks, and resources. Such support may be either direct or indirect in nature and may be widespread or only applicable to banking institutions with specific characteristics.

Some countries are able to take whatever steps are necessary to support their banks

^{3.} While recognizing that in many cases knowledge of this nature will take time to develop, it is particularly important because financial disclosure varies among countries. For this reason, meetings with head office management and the home country supervisors of FBOs are useful sources of information.

unequivocally while others will have a more limited degree of support for their banks due to legal restrictions or financial constraints. These factors should be reviewed, giving particular emphasis to past performance and an assessment of the country's resources.

Level of Transfer Risk

Transfer risk, which relates to the FBO's ability to access U.S. dollars, is an essential factor in determining whether the FBO can support its U.S. operations. For some FBOs, transfer risk is increased due to heavy debt servicing or other financial restraints relating to the home country, which often leads to exchange controls and hard currency restrictions. As a result, these FBOs may be limited in providing necessary support to their U.S. operations.

The assessment of transfer risk for individual countries is uniformly handled by U.S. regulators through the Interagency Country Exposure Review Committee (ICERC). These ICERC assessments can therefore be used in determining the SOSAs. For those countries not evaluated by ICERC, the assessments of transfer risk will made in the same manner as conducted by ICERC.

Generally, FBOs from countries rated substandard or worse would be accorded an assessment of no better than C. However, a high level of transfer risk associated with the FBO's home country could be mitigated by other considerations that clearly indicate that the FBO has broad access to U.S. dollars.

Other Factors

Determining whether an FBO poses any managerial or operational control risks to its U.S. operations can be influenced by a broad range of factors that are generally more subjective than those discussed under the first component of the SOSA. Any such risks, both actual and potential, which do not directly relate to the ability of an FBO to meet its obligations as discussed earlier, should be denoted by placing an asterisk beside the FBO's letter assessment. The nature of these risks should be discussed separately in the FBO evaluation.

One example of such control risks is an FBO that otherwise has a SOSA of A or B but may be

experiencing certain operational problems, not necessarily in the United States. The FBO may be undergoing extensive expansion into new markets or products that over time could pose a strain on its financial and managerial resources. The FBO also could be experiencing well-publicized internal control problems at offices outside the United States. Although these control problems would not necessarily affect the ability of the FBO to pay its obligations, they may be symptomatic of larger control problems that also might exist in the U.S. offices. Any such concerns should be explored to the extent possible, particularly as they may influence the examination plan for the FBO's U.S. operations.

GENERAL SUPERVISORY IMPLICATIONS

As discussed earlier, one of the principal goals of the SOSA is to identify those FBOs that may pose risks to their U.S. operations or to U.S. financial markets due to financial, operational, or other concerns at the FBO as a whole. The SOSA serves to categorize all FBOs conducting banking operations in the United States and to highlight those FBOs warranting higher levels of supervisory attention with respect to their U.S. operations. This assessment may influence the examination plan and potential supervisory follow-up actions for the FBO's U.S. operations.

An FBO's SOSA is taken into consideration in setting the examination plan for the FBO's U.S. operations. The examination plan considers any issues raised in the assessment process and addresses them accordingly. For example, the U.S. operations of FBOs whose assessments are marked by an asterisk may have examinations that specially target operational or management areas. The FBO's SOSA is also a factor in determining whether the FBO will be subject to a simultaneous examination.

The FBO's SOSA also is considered in implementing supervisory follow-up action for the U.S. operations. Generally, an assessment of C or worse would imply a level of concern that would subject the FBO's U.S. offices to at least periodic monitoring of their due to/due from positions. Any additional supervisory steps, such as imposing an asset pledge or asset maintenance requirement, would be implemented largely based on the condition and nature of the U.S. operations. An FBO accorded an assess-

ment of D or worse indicates a higher level of concern with some presumption of asset maintenance regardless of the condition of its U.S. operations.

As with all such supervisory follow-up actions, these steps are considered and implemented based on the general criteria for applying supervisory follow-up actions in the context of the FBO's SOSA. Supervisory follow-up action can be modified based upon a number of criteria. It is stressed that no automatic supervisory program is mandated as part of the FBO SOSA. Furthermore, an assessment of A or B generally would imply little if any concern relating to the ability of the FBO to meet its obligations. If an FBO does raise liquidity or solvency concerns, the FBO should not be accorded an assessment of A or B.

Suggested guidelines for supervisory follow-up action for each assessment category are as follows:

A or B Assessment—Normally, any supervisory follow-up action for FBOs with a SOSA of A or B is applied only if warranted by the condition of the U.S. operations. Supervisory measures generally would not relate to liquidation concerns. As such, asset maintenance usually would not be required for branches and agencies of these FBOs; however, supervisory actions would be undertaken, if necessary, to resolve any significant deficiencies in risk management, operations and internal controls, or compliance at any of the U.S. offices.

C Assessment—The FBO's SOSA is reviewed at least annually. The due to/due from position is closely monitored and any substantial due from position is fully analyzed for risk implications. If warranted by the condition of the combined U.S. operations or the asset quality at the U.S. offices of such an FBO, asset maintenance would be considered for branches and agencies, and U.S. subsidiary banks could be required to operate at capital levels above the minima.

D Assessment—There is a strong presumption of asset maintenance for branches and agencies of an FBO in this category, and U.S. bank subsidiaries should operate at strong capital levels. The FBO is more closely monitored and its assessment may be subject to review at least semi-annually.

E Assessment— The FBO will be placed under continuous surveillance and reporting as warranted. Termination proceedings for the U.S. operations of such an FBO will be considered under applicable regulatory guidelines.

DEVELOPING THE SOSA

The FBO's SOSA is developed annually through a process that involves all U.S. supervisors that have licensing, chartering, or examining responsibilities over the FBO's U.S. operations. The process includes an analysis of available information on the financial condition of the FBO within the context of the home country financial system, the banking supervisory system, the record of the authorities in preventing or successfully dealing with banking system problems, and transfer risk considerations. The FBO evaluations are based on information compiled by all of the relevant U.S. banking supervisory agencies.

Information obtained by any of the banking supervisory agencies relating to individual FBOs, their home country financial systems, supervisory systems and accounting policies should be transmitted to the Federal Reserve, which will assume responsibility for organizing and maintaining a database for this information. This database is available to all of the relevant U.S. banking supervisory agencies.

All of the relevant state and federal banking supervisory agencies, whenever possible, will obtain information for the database, especially as it relates to the individual FBOs, the financial systems within which they primarily operate and the supervisory systems in the different countries. This information will help to keep the database as current as possible and is developed primarily through discussions with the U.S. and head office managements of the FBOs as well as the home country supervisor(s).

PRIMARY PRODUCTS

The information in the database is used to develop three primary products, each of which summarizes information in the database and provides the supporting data for the SOSA. These three products are: (1) an evaluation of the financial condition of the FBO, (2) a review of the home country financial system, and (3) a

review of significant home country accounting policies and practices.

Evaluation of the Financial Condition of the FBO

Normally, the FBO evaluation is drafted by the Federal Reserve each year. The initial source of information for the evaluation is the FR Y7 report as well as any external sources that are readily available (e.g. periodicals and services). Over time, as the database becomes more developed, many additional sources of information will be utilized.

The individual Reserve Banks responsible for drafting FBO evaluations produce a schedule at the beginning of each year showing the approximate date that the draft evaluation and recommended SOSA for each FBO will be circulated for comments. This schedule is based primarily on the fiscal year-end of the FBO (and consequently the date the FR Y7 report is received), the extent and overall condition of the FBO's combined U.S. operations, and the prior SOSA of the FBO. This schedule is distributed to all of the state and federal agencies participating in this joint program along with the name of a contact person at each Reserve Bank. The other agencies, as well as the other Reserve Banks, may request, through the assigned contact person, that an FBO evaluation in any given year be given a higher priority than the schedule indicates.

The draft evaluation and the proposed SOSA is circulated for comments within the Federal Reserve System and to all federal and state supervisory agencies involved in supervising the FBO. Each party reviews the draft and comments, if necessary. In addition, the analyst who prepared the draft will be available to answer questions regarding the draft. If the initial review of the draft indicates differences in view regarding the proposed assessment that can not be resolved informally, a meeting of the relevant banking supervisory agencies could be called by any supervisory agency to discuss the SOSA of the FBO. While it is expected that a consensus assessment will result from this process, individual agencies retain the right to exercise all statutory authorities available to them to meet their supervisory concerns.

The finalized evaluation is sent to all of the supervisory agencies involved in the supervision

of the U.S. operations of the FBO. The evaluations and assessments normally are reviewed annually. The evaluations will be revised in the interim only if information is obtained by any of the U.S. supervisory agencies that is significant enough to change the SOSA, either positively or negatively.

These evaluations are kept strictly confidential by each of the agencies, in part to ensure that the sharing of information between the agencies for purposes of analyzing the condition of the FBO and assigning its SOSA does not violate state or federal regulations.

Review of Home Country Financial System

As mentioned above, a database containing information on the financial system of each country with bank representation in the United States is maintained by the Federal Reserve, using its own sources and information submitted by the other supervisory agencies. This information is made available to all of the agencies. In addition, the Federal Reserve provides, in a uniform format, reviews summarizing information on the home country financial system, the nature of banking supervision and the country's record in dealing with banking problems.4 These reviews are updated whenever any of the supervisory agencies obtain significant information regarding the financial system of the particular country. The database includes all such reviews prepared by the Federal Reserve and any provided by the other supervisory agencies.

Review of Home Country Accounting Practices

The database also contains information on significant accounting policies and practices in other countries and is utilized to develop reviews of such practices. These reviews are developed by the Federal Reserve utilizing information

^{4.} These reviews are produced based on a schedule provided by the Reserve Banks. The schedules give priority to those countries that have a major banking presence in the United States or are experiencing significant problems within the home country financial system. The draft is provided to the other agencies for their comments. The analyst who prepared the draft is available to answer questions regarding the draft.

derived from the same sources as used for the review of the home country financial system as well as from general accounting information provided in the FR Y7 report. These reviews are updated whenever any significant changes occur in accounting policies or practices.

Examination Planning and the Assessment of the U.S. Operations of Foreign Banking Organizations

Effective date July 1997 Section 2002.1

OVERVIEW

This segment of the program is designed to provide a more efficient, rational, and uniform approach to supervising the U.S. operations of foreign banking organizations (FBOs), particularly those that operate in the United States through numerous entities and across multiple jurisdictions. In order to ensure coordination of supervisory efforts and avoid duplication, the U.S. banking supervisory agencies communicate with each other to a greater extent regarding their examination plans, examination results, and, where applicable, their proposed supervisory follow-up actions. In addition, the Federal Reserve assesses annually the combined U.S. operations of each FBO, based largely on input from and discussions with the examining agencies.

EXAMINATION SCHEDULING AND DEVELOPMENT OF EXAMINATION PLANS

FBSEA requires that each U.S. branch and agency of an FBO be subject to one safety and soundness examination in each twelve month period. More frequent examination may be warranted in certain situations.¹

To ensure coordination, the licensing and insuring agencies provide the local Federal Reserve Bank with a copy of their preliminary examination schedule for the coming year for all U.S. offices of an FBO for which the agency anticipates conducting an examination. The Federal Reserve uses these schedules, along with the preliminary examination schedules of the various Reserve Banks, to derive a draft comprehensive examination schedule for all U.S. operations of individual FBOs.

The draft schedule is provided to each involved agency in order to permit all of the examining agencies to review their own schedules in conjunction with those of the other agencies. In addition, where necessary, an interagency

scheduling meeting takes place each year to determine the scope and timing of examinations of FBOs that are to be conducted on a more coordinated basis. The Federal Reserve finalizes the comprehensive examination schedule and provides it to all of the supervisory agencies.

For FBOs that conduct all or substantially all of their U.S. operations through entities licensed or chartered by one banking supervisory agency, the timing of the annual examination is established by the licensing authority. In agreement with the individual states, the Federal Reserve and, for insured branches, the FDIC, share the burden of conducting the annual examinations of state-licensed branches and agencies. In those years that the Federal Reserve or FDIC conduct the examination, the timing will be established by that agency.

FBOs which operate in the United States through multiple offices often will have all offices examined using the same "as of" financial statement date. This provides the supervisory agencies with increased information on the interrelationships among the various offices and can enhance the examination of individual offices and the FBO's overall U.S. operations. These examinations are conducted by the various agencies.

Sometimes, certain activities of a branch are functionally managed or operationally performed at the branch being examined, but are booked at another office of the FBO, either in the U.S. or offshore. It is not uncommon for one branch to generate, or be responsible for loans, trading assets, or deposits that are ultimately booked at another office. Similarly, it also is not uncommon for a branch to perform certain operations such as electronic data processing, accounting, financial reporting, or credit administration on behalf of another office of the FBO. Even when a U.S. branch performs limited operational functions for a related office, examiners should evaluate whether the branch has sufficient records and controls in place to execute the delegated responsibilities. If there is insufficient information to evaluate the nature of and the performance of the U.S. branch with respect to the business relationship with another office of the FBO, examiners should cite this deficiency in the report of examination as a matter that requires immediate attention.

Under legislation passed in 1996, branches and agencies that meet certain size and other criteria may be examined once in every 18 month period. Those criteria currently are under development and further guidance will be issued.

SR 96-36 provides detailed guidance on how to review duties performed by one branch on the behalf of another. Essentially, a branch performing duties on behalf of another office of the FBO should have adequate policies, procedures, and documentation to clearly delineate the oversight, operational, and control responsibilities of the branch. There should be adequate risk management processes, operational controls, and compliance programs covering all activities for which the branch has responsibility. The examination treatment under the ROCA rating system for activities conducted by a U.S. branch on behalf of another office of the FBO should be the same as for activities conducted by the branch for its own book, except for the evaluation of asset quality. In rating asset quality, the examiner should only evaluate assets that are on the books of the U.S. branch. However, examiners should be mindful of the general quality of assets being generated by the U.S. branch and booked elsewhere so as to be alert to any pattern of booking low quality assets outside the U.S. or any other situations that might indicate problems in risk management or operational controls.

EXAMINATION PLAN

Subsequent to the examination scheduling process, detailed examination plans are developed, exchanged and coordinated among the examining agencies. Each state and federal supervisory agency participating in this program is committed to developing, to the extent possible, examination plans for individual offices of FBOs that they plan to examine based primarily on the following:

- findings and scope of previous examinations;
- the results of any off-site surveillance;
- the latest assessment of the combined U.S. operations of the FBO and the role of the office in the context of the FBO's overall U.S. business activities:
- · results of meetings with both U.S. and head office management of the FBO, and the home country supervisor(s); and,
- the evaluation of the FBO and the SOSA assigned.

A comprehensive examination plan ("Exam Plan") is developed annually for each FBO with banking offices licensed by more than one

supervisory agency and/or with significant U.S. non-banking activities. The Federal Reserve drafts the comprehensive Exam Plan based on the individual examination plans prepared by the different state and federal supervisory agencies for each office to be examined. These examination plans should be developed after the regulatory agency has completed its most recent examination of the FBO entity subject to its supervision. The plan should be incorporated into the confidential section of the examination report. After conferring with other participating banking supervisory agencies, the scope or timetable of an examination, as set out in the annual comprehensive Exam Plan, may be altered in the event there are impediments to completing an examination as originally planned.

IMPLEMENTING THE ANNUAL EXAMINATION PLAN

The Federal Reserve coordinates the sharing of information throughout the examinations of FBOs with multi-state operations. Because of the differing starting dates and lengths of individual examinations, most examinations are completed by participating banking supervisory agencies at different times. Consequently, an important part of this program is the sharing of critical examination findings throughout the process. The U.S. supervisory agencies have committed to advising those agencies responsible for examining other U.S. offices of the FBO of any critical examination findings prior to the exit meeting for that examination.

The Federal Reserve, in its statutory role as umbrella authority with responsibility for overall U.S. operations, confers with the examining agencies to determine if its participation in any of the examiner closeout meetings is warranted. Such participation typically is appropriate in the event there are systemic weaknesses detected in the U.S. operations or problems exist that are so significant as to affect the rating of the overall U.S. operations. In those instances where a Federal Reserve Bank has conducted the examination, that Reserve Bank confers with the licensing agency to determine if the participation of that agency is warranted. However, the normal presumption is that the banking supervisory agency that conducted the examination also will conduct the closeout meeting without participation by non-examining agencies.

The agency responsible for the examination of any office in a given year is also responsible for completion of the examination and preparation of the examination report for that entity. In the case of joint examinations, the examining agencies strive to issue only one report of examination for that office of the FBO. The supervisory agency that conducted the examination of an individual office of an FBO also is responsible for the distribution of the transmittal letter and examination report.

Supervisory actions that affect only one office of an FBO also normally are entered into solely by the licensing authority, unless the action resulted from an examination conducted by the FDIC or the Federal Reserve. In these cases the action is undertaken by the examining agency or, at the option of the licensing authority, on a joint basis with that authority. Actions that apply to the overall operations of an FBO are entered into by the Federal Reserve and those licensing or insuring agencies that have offices affected by the supervisory action and wish to enter into such an action with the office they license.

ASSESSMENT OF COMBINED U.S. OPERATIONS AND ASSIGNMENT OF A RATING

An important component of this program is the integration of individual examination findings into an assessment of an FBO's entire U.S. operations. This assessment provides the FBO and the U.S. supervisory agencies with a view of the overall condition of the U.S. operations, and helps put into context the strengths and weaknesses of individual offices. It also highlights supervisory concerns regarding any problems that are pervasive in the U.S. operations of the FBO.

The Federal Reserve conducts an annual assessment of the combined U.S. operations and prepares a "Summary of Condition" for all FBOs with U.S. offices supervised by more than one agency. The summary includes an assessment of all risk factors, including (1) all elements of the ROCA rating system, (2) quality of risk management oversight employed by all levels of management in the FBO's U.S. operations, and (3) the examinations of all vehicles of the FBO conducted during the year. The Summary of Condition leads to the assignment of a single-component rating between 1 and 5 for the

combined U.S. operations.

The Summary of Condition is drafted by the Federal Reserve which provides a copy of the draft and proposed rating to each supervisory agency with examination authority over an office of the FBO in order to make certain that information obtained from these agencies was correctly interpreted.

Once the Summary of Condition is finalized, the Federal Reserve provides a copy, including the rating, to the Chief Executive Officer at the head office of the FBO. The Summary of Condition and the rating serve as a starting point in drafting the Exam Plan for the next year.

In arriving at the rating for the combined U.S. operations of the FBO, all of the FBO's U.S. vehicles are considered; however, this rating is not based merely on an arithmetic average of the examination ratings of the vehicles examined. The strengths or weaknesses exhibited within individual entities are evaluated based on the size and importance of the entity relative to the FBO's entire U.S. operations, and the materiality and extent of the weaknesses.

The five ratings are defined as follows:

Combined Rating of I—The overall operations are fundamentally sound in every respect. They cause no supervisory concern and require only normal supervisory attention.

Combined Rating of 2—The combined U.S. operations operate in a basically sound manner, but may have modest weaknesses that can be corrected by management in the normal course of business. They do not require more than normal supervisory attention.

Combined Rating of 3—Overall U.S. operations are weak in risk management, operational controls, and compliance, or have numerous asset quality problems that in combination with the condition of the FBO cause supervisory concern. U.S. and/or head office management may not be taking the necessary corrective actions to address weaknesses. This rating may also be assigned when either risk management, operational controls, or compliance is individually viewed as unsatisfactory. Generally, these operations raise supervisory concern and require more than normal supervision to address their weaknesses.

Combined Rating of 4—The combined U.S. operations have a significant volume of serious

weaknesses. Serious problems or unsafe and unsound banking practices or operations exist, which have not been satisfactorily addressed or resolved by U.S. or head office management. These operations require close supervisory attention and surveillance monitoring and a definitive plan for corrective action by head office management.

Combined Rating of 5-The combined U.S. operations have so many severe weaknesses or unsafe and unsound conditions that they require urgent restructuring by head office management.

This composite assessment serves to apprise the various U.S. supervisory authorities of the condition of all the U.S. entities of individual FBOs. These agencies can then factor the information that they obtain from the Summary of Condition and the composite assessment into their supervision of the U.S. entities under their jurisdiction.

Rating System for U.S. Branches and Agencies of Foreign Banking Organizations

Effective date July 1997

Section 2003.1

The rating system for U.S. branches of FBOs is a management information and supervisory tool designed to assess the condition of a branch and to identify significant supervisory concerns at a branch in a systematic and consistent fashion. The rating system (ROCA) has been revised from the previous rating system of asset quality, internal controls, and management (AIM), to better assess the condition of a branch within the context of the FBO, of which it is an integral part, and to pinpoint the key areas of concern in a branch office.

For evaluation purposes, the rating system divides a branch's overall activities into three individual components: risk management, operational controls, and compliance. These components represent the major activities or processes of the branch that may raise supervisory concern. The rating system also provides for a specific rating of the quality of the branch's stock of assets as of the examination date.

COMPOSITE RATING

The overall or composite rating indicates whether, in the aggregate, the operations of the branch may present supervisory concerns and the extent of any concerns. While the individual component ratings are taken into consideration in arriving at the branch's overall assessment, the composite rating should not be merely an arithmetic average of the individual components. The examiner should assign and justify in the report a composite rating using definitions provided below as a guide.¹

The composite rating is based on a scale of one through five in ascending order of supervisory concern. Thus, one represents the lowest level of supervisory concern while five represents the highest level. The five composite ratings are defined as follows.

Composite Rating 1

Branches in this group are strong in every respect. These branches require only normal supervisory attention.

Composite Rating 2

Branches in this group are in satisfactory condition, but may have modest weaknesses that can be corrected by branch management in the normal course of business. Generally, they do not require additional or more than normal supervisory attention.

Composite Rating 3

Branches in this group are viewed as fair due to a combination of weaknesses in risk management, operational controls, and compliance, or asset quality problems that, *in combination with* the condition of the FBO or other factors, cause supervisory concern. In addition, branch and/or head office management may not be taking the necessary corrective actions to address substantive weaknesses. This rating may also be assigned when risk management, operational controls, or compliance is individually viewed

loans, but is otherwise poorly managed should not be given undue credit for having good asset quality. Alternatively, a branch that is designated to hold problem assets generated by other offices of the FBO, in order to better manage the workout process, should not be penalized, so long as the FBO has the ability to support the level of problem assets.

Finally, it should be recognized that asset quality tends to be a "trailing" indicator of branch performance. In instances where risk management systems are weak, but problem assets are currently nominal, it is realistic to assume there will be future deterioration in asset quality. By the same measure, management should be given credit in the overall evaluation where the causes of past asset quality problems have been corrected.

^{1.} Assessment of asset quality is an integral part of any examination; however, under certain circumstances, it may be appropriate to give the individual asset quality rating component greater or lesser weight in arriving at an overall composite rating. In ensuring the protection of branch creditors, an important factor is the strength of the FBO. As the financial strength of the FBO weakens, it becomes increasingly important to look to the quality of the assets booked in the United States as the source of protection for local creditors, and, at a certain point, asset maintenance should be imposed. Similarly, where the FBO is strong, and the need to look to local assets for protection of creditors seems remote, the relative weighing of the asset quality component in the overall evaluation diminishes.

It also should be recognized that different offices of the FBO can be assigned widely different roles in the FBO's overall strategy. Thus, an individual office that books very few

as unsatisfactory. Generally, these branches raise supervisory concern and require more than normal supervisory attention to address their weaknesses.

Composite Rating 4

Branches in this group are in marginal condition due to serious weaknesses as reflected in the assessments of the individual components. Serious problems or unsafe and unsound banking practices or operations exist, which have not been satisfactorily addressed or resolved by branch and/or head office management. Branches in this category require close supervisory attention and surveillance monitoring and a definitive plan for corrective action by branch and head office management.

Composite Rating 5

Branches in this group are in unsatisfactory condition due to a high level of severe weaknesses or unsafe and unsound conditions and consequently require urgent restructuring of operations by branch and head office management.

DISCLOSURE

Following approval of the rating by appropriate senior supervisory officials at the examining agency, the numeric ratings for all components as well as the overall composite rating should be disclosed in the open, summary section of the examination report. This also applies when conducting meetings with senior management. In disclosing the rating, its meaning should be explained clearly using the appropriate composite rating definition. The report should also make it clear that the rating is part of the overall findings of the examination and is thus confidential. Any rating disclosed or discussed at an examination closeout meeting should be held out by the examiner-in-charge to be tentative.

COMPONENT EVALUATIONS

Similar to the composite rating, the individual rating components are evaluated on a scale of

one to five, where one represents the lowest level of supervisory concern and five represents the highest. Each component is discussed below followed by a description of the individual performance ratings.

Risk Management

Risk is an inevitable component of any financial institution. Risk management, or the process of identifying, measuring, and controlling risk, is therefore an important responsibility of any financial institution. In a branch, which is typically removed from its head office by location and time zone, an effective risk management system is critical not only to manage the scope of its activities but to achieve comprehensive, ongoing oversight by branch and head office management. In the examination process, examiners will therefore determine the extent to which risk management techniques are adequate (i) to control risk exposures that result from the branch's activities and (ii) to ensure adequate oversight by branch and head office management and thereby promote a safe and sound banking environment.

The primary components of a sound risk management system are a comprehensive risk assessment approach; a detailed structure of limits, guidelines, and other parameters used to govern risk taking; and a strong management information system for monitoring and reporting risks

The process of risk assessment includes the identification of all the risks associated with the branch's balance sheet and off-balance-sheet activities and grouping them into appropriate risk categories. These categories broadly relate to credit, market, liquidity, operational, and legal risks.² All major risks should be measured explicitly and consistently by branch management; risks should also be reevaluated on an ongoing basis as underlying risk assumptions relating to economic and market conditions vary and as the branch's activities change. The branch's expansion into new products or business lines should not outpace proper risk management or supervision by head office. Where risks cannot be explicitly measured, manage-

While operational risks are identified as part of the branch's overall risk assessment process, the effectiveness of the branch's operational controls is separately evaluated under ROCA.

ment should demonstrate knowledge of their potential impact and a sense of how to manage such risks.

Risk identification and measurement are followed by an evaluation of the tradeoff between risks and returns to establish acceptable risk exposure levels, which are stated primarily in the branch's lending and trading policies subject to the approval of head office management. These policies should give standards for evaluating and undertaking risk exposure in individual branch activities as well as procedures for tracking and reporting risk exposure to monitor compliance with established policy limits or guidelines.

Head office management has a role in developing and approving the branch's risk management system as part of its responsibility to provide a comprehensive system of oversight for the branch. Generally, the branch's risk management system, including risk identification, measurement, limits or guidelines, and monitoring should be modeled on that of the FBO as a whole to provide for a fully-integrated risk management system.³

In assigning the risk management rating, examiners should evaluate the current, ongoing situation and concentrate on developments since the previous examination. The rating should not concentrate on past problems, such as those relating to the current quality of the branch's stock of assets, if risk management techniques have improved significantly since those problems developed.⁴

More specifically, in rating the branch's risk management procedures, examiners should consider the following.

- The extent to which the branch is able to manage the risks inherent in its lending, trading, and other activities, specifically its ability to identify, measure, and control these risks.
- The soundness of the qualitative and quantitative assumptions implicit in the risk management system.

- Whether risk policies, guidelines, and limits at the branch are consistent with its lending, trading, and other activities; management's experience level; and the overall financial strength of the branch and/or the FBO.
- Whether the management information system and other forms of communication are consistent with the level of business activity at the branch and sufficient to accurately monitor risk exposure, compliance with established limits, and sufficient to enable the head office to monitor the real performance and risks of the branch.
- Management's ability to recognize and accommodate new risks that may arise from the changing environment, and to identify and address risks not readily quantified in a risk management system.

For example, in the lending area, a branch is expected to have (1) experienced lending officers, an effective credit approval and review function, and, where appropriate, credit workout personnel; (2) a credit risk evaluation system that is adequate in assessing relative credit risks; (3) branch officer lending limits, lending guidelines, and portfolio policies consistent with the abilities of branch personnel and the financial expertise and resources of the FBO; (4) a system that identifies existing and potential problem credits, a method for assessing the likely impact of those credits on existing and future profits, and procedures for accurately informing head office of the credit quality of the portfolio and possible credit losses; and (5) procedures for assessing the impact on the portfolio of specific or general changes in the business climate.

A rating of I indicates that management has a fully-integrated risk management system that effectively identifies and controls all major types of risk at the branch, including those from new products and the changing environment. This assessment, in most cases, will be supported by a superior level of financial performance and asset quality at the branch. No supervisory concerns are evident.

A rating of 2 indicates that the risk management system is fully effective with respect to almost all major risk factors. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the branch's business plan.

^{3.} For a more detailed overview of the risk management process in trading operations, refer to the Federal Reserve's *Trading Activities Manual*.

^{4.} Thus, for example, the change in the level of problem assets since the previous examination is normally more important than the absolute level of problem assets. At the same time, a loan portfolio that has few borrowers experiencing debt service problems does not necessarily indicate a sound risk management system because weak underwriting standards may make the branch vulnerable to credit problems during a future economic downturn.

While the branch may have residual risk-related weaknesses, these problems have been recognized and are being addressed by the branch and/or head office. Any such weaknesses will not have a material adverse affect on the branch. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.

A rating of 3 signifies a risk management system that is lacking in some important measures. Its effectiveness in dealing with the branch's level of risk exposures is cause for more than normal supervisory attention, and deterioration in financial performance indicators is probable. Current risk-related procedures are considered fair, existing problems are not being satisfactorily addressed, or risks are not being adequately identified and controlled. While these deficiencies may not have caused significant problems yet, there are clear indications that the branch is vulnerable to risk-related deterioration.

A rating of 4 represents a marginal risk management system that generally fails to identify and control significant risk exposures in many important respects. Generally, such a situation reflects a lack of adequate guidance and supervision by head office management. As a result, deterioration in overall performance is imminent or is already evident in the branch's overall performance since the previous examination. Failure of management to correct risk management deficiencies that have created significant problems in the past warrants close supervisory attention.

A branch rated 5 has critical performance problems that are due to the absence of an effective risk management system in almost every respect. Not only are there a large volume of problem risk exposures, the problems are also intensifying. Management has not demonstrated the capability to stabilize the branch's situation. If corrective actions are not taken immediately, the operations of the branch are severely endangered.

Operational Controls

This component assesses the effectiveness of the branch's operational controls, including accounting and financial controls. The assessment is based on the expectation that branches should have an independent internal audit function and/or an adequate system of head office or external audits as well as a system of internal controls consistent with the size and complexity of their operations. In this regard, internal audit and control procedures should ensure that operations are conducted in accordance with internal guidelines and regulatory policies and that all reports and analyses provided to the head office and branch senior management are timely and accurate.

The rating of operational controls should include the following.

- The adequacy of controls and the level of adherence to existing procedures and systems. (These are separate but related factors.)
- The frequency, scope, and adequacy of the branch's internal and external audit function, relative to the size and risk profile of the branch, and the independence of the internal audit function from line management.
- The number and severity of internal control and audit exceptions.
- Whether internal control and audit exceptions are effectively tracked and resolved in a timely manner
- The adequacy and accuracy of management information reports. This assessment should be based primarily on whether reports and analyses are sufficient to properly inform head office management of the branch's condition on a timely basis, and whether there are sufficient procedures to ensure the accuracy of those reports.
- Whether the system of controls is regularly reviewed to keep pace with changes in the branch's business plan and laws and regulations.

A branch that is rated 1 has a fully comprehensive system of operational controls that protects against losses from transactional and operational risks and ensures accurate financial reporting. Branch operations are fully consistent with sound market practices. The branch also has a well-defined and independent audit function that is appropriate to the size and risk profile of the branch. No supervisory concerns are evident.

A rating of 2 may indicate some minor weaknesses, such as the presence of new business activities where some modest control defi-

ciencies exist, but which management is addressing. Some recommendations may be noted. Overall, the system of controls, including the audit function, is considered satisfactory and effective in maintaining a safe and sound branch operation. Only routine supervisory attention is required.

A rating of 3 indicates that the branch's system of controls, including the quality of the audit function, is lacking in some important respects, particularly as indicated by continued control exceptions and/or substantial deficiencies in or failure to adhere to written policies and procedures. As a result, more than normal supervisory attention is required.

A branch that is rated 4 signifies that the system of operational controls has serious deficiencies that require substantial improvement. In such a case, the branch may lack control functions, including those related to the audit function, that meet minimal expectations; therefore, adherence to bank and regulatory policy is questionable. Head office management has failed to give the branch proper support to maintain operations in accordance with U.S. norms. Close supervisory attention is required.

A branch that is rated 5 lacks a system of operational controls to such a degree that its operations are in serious jeopardy. The branch either lacks or has a wholly deficient audit function. Immediate substantial improvement is required by branch and head office management, along with strong supervisory attention.

Special audit procedures are required when both the O component and the composite rating are 3 or worse. If both the O component and the composite rating are 3, the special audit procedures may be performed by the internal audit function if, and only if, the audit function is considered satisfactory. If the internal audit function is less than satisfactory, or if both the O component and composite rating are 4 or worse, then an external audit is required. An external audit also is required if the internal auditors had performed the special audit procedures following the previous examination, and the O and composite ratings are again assigned a 3 rating. As significant internal control weaknesses in the operations of one office may be an indication of systemic weaknesses in other branches as well, the special audit procedures may be applied to other U.S. offices of the FBO. SR 96-27 provides additional guidance regarding these special audits.

Compliance

In addition to maintaining an effective system of operational controls, branches should also demonstrate compliance with all applicable state and federal laws and regulations, including reporting and special supervisory requirements. To the extent possible given the size, risk profile and organizational structure of the branch, these responsibilities should be vested in a branch official or compliance officer whose function is separate from line management. Branch management should also ensure that all appropriate personnel are properly trained in meeting regulatory requirements on an ongoing basis. The scope of the branch's audit function also should ensure that the branch is meeting all applicable regulatory requirements.

Accordingly, the branch's level of compliance should be rated based on the following factors.

- The level of adherence to applicable state and federal laws and regulations and any supervisory follow-up actions.
- The effectiveness of (i) written compliance procedures and (ii) training of line personnel charged with maintaining compliance with regulatory requirements.
- Management's ability to submit required regulatory reports in a timely and accurate manner.
- Management's ability to identify and correct compliance issues.
- Whether the internal audit function checks for compliance with applicable state and federal laws and regulations.

A branch accorded a rating of 1 demonstrates an outstanding level of compliance with applicable laws, regulations, and reporting requirements. No supervisory concerns are evident.

A rating of 2 indicates that compliance is generally effective with respect to most factors. Compliance monitoring and related training programs are sufficient to prevent significant problems. Minor reporting errors may be present, but they are being adequately addressed by branch management. Only normal supervisory attention is warranted.

A branch that is rated 3 has deficiencies in management and training systems that result in an atmosphere where significant compliance problems could and do occur. Such deficiencies could include a lack of written compliance procedures, no system for identifying possible compliance issues, or a substantial number of minor or repeat violations or deficiencies. More than normal supervisory attention is warranted.

A rating of 4 indicates that compliance matters are not given proper attention by branch and head office management and close supervisory attention is warranted. The lack of an effective compliance program, including an ongoing training program, may be evident along with a failure to meet significant regulatory requirements and/or significant, widespread inaccuracies in regulatory reports.

A rating of 5 would signal that attention to compliance matters is wholly lacking at the branch to the extent that immediate supervisory attention is warranted.

Asset Quality

Generally, asset quality is evaluated to determine whether a financial entity has sufficient capital to absorb prospective losses and, ultimately, whether it can maintain its viability as an ongoing entity. The evaluation of asset quality in a branch does not have the same result because a branch is not a separately capitalized entity. Instead, a branch relies on the financial and managerial support of the FBO as a whole.

Nonetheless, the evaluation of asset quality is important both in assessing the effectiveness of credit risk management and in the event of a possible liquidation of a branch. However, as indicated above, a branch is not strictly limited by its own internal and external funding sources in meeting solvency and liquidity needs. The

ability of a branch to honor its liabilities ultimately is based upon the condition and level of support from the FBO, a concept that is integral to the FBO supervision program.

This concept states that if the condition of the FBO is satisfactory, the FBO is presumed to be able to support the branch with sufficient resources on a consolidated basis. As a result, the assessment of asset quality in such circumstances would not in and of itself be a predominant factor in the branch's overall assessment, if existing risk management techniques are satisfactory. If, however, support from the FBO is questionable, the evaluation of asset quality should be carefully considered in determining whether supervisory actions are needed to improve the branch's ability to meet its obligations on a stand-alone basis. In cases where a branch is subject to asset maintenance, it is expected that asset quality issues will be addressed by disqualifying classified assets as eligible assets.

The quality of the branch's stock of assets is evaluated based on the following factors. Generally, credit administration concerns should be addressed in rating risk management.

- The level, distribution, and severity of asset and off-balance-sheet exposures classified for credit and transfer risk.⁵
- The level and composition of nonaccrual and reduced rate assets.

A branch rated 1 has strong asset quality.

A branch rated 2 has satisfactory asset quality.

A branch rated 3 has fair asset quality.

A branch rated 4 has marginal asset quality.

A branch rated 5 has unsatisfactory asset quality.

^{5.} The various state and federal agencies may differ in terms of specific practices and methodologies used to implement the above guidelines. For further guidance in this area, examiners should consult with their respective agencies.

Section 2010.1

Risk-focused examinations emphasize effective planning and scoping in order to customize examinations to the size and activities of the institution and to concentrate examiner resources on areas that expose the institution to the greatest degree of risk. In addition, under a risk-focused approach, the resources directed to assessing an organization's management are generally increased, while the degree of transaction testing may be reduced in order to minimize the regulatory burden.

Transaction testing includes the reconciliation of internal accounting records to financial reports (in order to evaluate the accuracy of account balances), the comparison of day-to-day practices to the office's policies and procedures (in order to assess compliance with internal systems), and all other supervisory testing procedures, such as the review of the quality of individual loans and investments. Risk-focused examinations still require an appropriate level of transaction testing to verify (1) the adequacy of, and adherence to, internal policies, procedures, and limits; (2) the accuracy and completeness of management reports and financial records; and (3) the adequacy and reliability of internal control systems. However, under a risk-focused examination approach, the degree of transaction testing should be reduced when internal risk management processes are determined to be adequate or risks considered minimal.

Generally, advance notification of an examination is given to enable branch management to have the necessary information available for examiners when they arrive on-site. This practice results in significant savings in time and personnel resources. However, surprise or nonroutine examinations may be conducted at any time at the examining agency's discretion.

PURPOSE OF PRE-EXAMINATION PREPARATION

Pre-examination planning results in more effective examinations that are focused on risks particular to the specific institution and thus minimizes regulatory burden. Further, such planning facilitates close coordination with other state and Federal banking agencies and allows information requests to be better tailored to the specific institutions.

RISK ASSESSMENT

In order to focus procedures on the areas of greatest risk to the branch, a risk assessment should be performed in advance of the on-site work. The risk assessment process highlights both the strengths and the vulnerabilities of the institution and provides a foundation from which to determine the procedures to be conducted during an examination. Risk assessments entail the identification of the financial activities in which a banking organization has chosen to engage, the determination of the types and quantities of risk, and the consideration of the quality of the management and control of these risks. At the conclusion of the risk assessment process, a preliminary supervisory strategy for the institution and each of its major activities can be formulated. Those activities that are most significant to the organization's risk profile or that have inadequate risk management processes or rudimentary internal controls represent the highest risks to the institution and should undergo the most rigorous scrutiny and testing.

Identifying the significant activities of an institution is the first step in the risk assessment process. These activities may be identified through the review of prior examination and inspection reports and workpapers, surveillance and monitoring reports generated by the Board and Reserve Bank staff, regulatory reports, and other relevant supervisory material. Once significant activities have been identified, the types and quantities of risks to which these activities expose the institution should be determined. This allows identification of the high risk areas that should be emphasized during the examination. The types of risk which may be encountered individually or in various combinations are credit, market, liquidity, operational, legal, or reputational. These risk types are discussed further in Section 3000.1 of this manual.

The quantity of risk can be determined by a number of factors. For example, in order to assess the quantity of credit risk in loans and commitments, the level of past due loans, internally classified or watch list loans, nonperforming loans, and concentrations of credit to particular industries or regions should be considered. In addition, the examiner should consider the trends in special mention and classified loans and historic chargeoff levels.

Once the types and quantities of risk in each activity have been identified, a preliminary assessment of the process in place to identify, measure, monitor, and control these risks should be completed. Sound risk management will vary from branch to branch, but generally include four basic elements. These are: (1) active senior management oversight, (2) adequate policies, procedures, and limits, (3) adequate risk measurement, monitoring, and management information systems, and (4) comprehensive internal audits and controls.

Ordinarily the pre-examination preparation is performed by the examiner-in-charge or designee and one or more assistants. Time requirements for this preparation may vary considerably depending upon the size, complexity, and condition of the branch being examined. The timing should allow overall scheduling efficiency and should consider such factors as the number and experience of participating personnel, geographic location of the branch, and the results of previous examinations. Scheduling factors may result in the pre-examination preparation being performed from many weeks before the start of the examination to the week immediately preceding the examination.

ASSIGNMENT AND SUPERVISION OF PERSONNEL

Early review allows the examiner-in-charge the greatest flexibility in determining the number of examining personnel needed and any special expertise required.

The examiner-in-charge must be able to prioritize critical categories of the examination and determine the optimum timing of simultaneous activities. Budgeting and allocating human resources should include the following considerations:

- Assignment of examiners based on their skills/ expertise and examination objectives.
- Assignment of priorities to avoid duplication of effort and ensure timely completion of the examination.
- Coordination with other regulatory agencies that may be conducting a joint, concurrent, or related office examination.
- Assignment of examining personnel in a manner to maintain an even workload throughout the examination.

GENERAL GUIDELINES FOR PRE-EXAMINATION PREPARATION

Because the primary purpose of the preexamination preparation is to determine examination objectives and scope, only general guidelines for the procedures to be performed can be given. Accordingly, the procedures that follow may be modified to fit the specific circumstances encountered. General guidelines for preexamination preparation include:

- Reviewing the examination strategy/annual examination plan developed by the appropriate supervisory authorities.
- Reviewing examination manuals, programs, and regulatory letters applicable to the examination.
- Reviewing all other available analyses prepared by the coordinating Reserve Bank and other supervisory agencies.
- Reviewing all available regulatory reports, including the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002) and the Country Exposure Report (FFIEC 019).
- Reviewing the branch's strategic or business plan, if available. This plan, provided by the branch, can be useful in examination planning, as it may indicate new or discontinued services that could affect the scope and direction of the examination. The plan can also serve as a reference between examinations. The plan usually contains goals and prospects for the branch over the next business period, indicating target markets and the expected level of profitability and other performance standards to be achieved.
- Reviewing the following list of branch services and products to determine their importance to the examination:
 - Deposit services: checking, automatic funds transfer, telephone transfer;
 - Credit services: commercial loans, overdraft banking, installment loans, mortgage lending, letters of credit, bills discounted;
 - EDP services;
 - Securities trading and off-balance sheet activities, including foreign exchange;
 - Fiduciary activities; and
 - Private banking.
- Reviewing all related examination and visitation reports, correspondence, enforcement

actions, minutes, and memoranda of significance.

- Coordinating with other pertinent regulatory agencies or units, particularly in the case of special examinations resulting from novel or unusual situations. Determining which related organizations are to be examined and the extent of the procedures to be performed.
- Completing personnel assignments and coordinating with assisting personnel regarding any preliminary procedures that are to be performed.
- Determining the cut-off line or the appropriate statistical sampling technique to be used for performing risk asset review. Note any unusual considerations that may affect the establishment of the factors.
- Reviewing and customizing the First Day Letter before presentation to branch management; early presentation permits timely completion of bank-prepared information.

Upon completion of the pre-examination preparation, the scope of the examination should be established and a planning memorandum should be developed. Accomplishing the foregoing tasks before starting the examination will provide for an efficient examination, consistent with established objectives.

DETERMINING THE SCOPE OF THE EXAMINATION

Full-scope examinations under a risk-focused approach are not comprised of a fixed set of routine procedures. Rather, the procedures that must be performed to fulfill the objectives of a full-scope examination must be adjusted depending on the circumstances of the institution being evaluated. At a minimum, however, full-scope examinations should include sufficient procedures to reach an informed judgement on the risk management, operational, and compliance factors rated under ROCA.

If necessary, the examiner-in-charge should meet with the principal branch officers before the start of the examination to determine the breadth of their individual responsibilities. The examiner-in-charge should determine at this meeting whether any important developments have occurred since the previous examination or if any planned or probable events are expected in the near-term. Arrangements should be made with branch personnel as to the level of their assistance required during the examination.

Discussions should be held with any examiners offering specialized assistance during the examination, for example, consumer affairs, EDP, or audit, to determine the scope of their review and the inclusion of those results within the context of the overall examination report, if so planned.

At this point in time, the scope of the examination should be developed so as to facilitate the development of a First Day Letter applicable to the branch being examined.

PREPARATION OF A SCOPE MEMORANDUM

Once the examination planning and risk assessment processes are completed, a scope memorandum should be prepared. A scope memorandum provides a detailed summary of the supervisory strategy for an institution and assigns specific responsibilities to examination team members. A scope memorandum should be tailored to the size and complexity of the institution, should define the objectives of each examination, and generally should include:

- Name and location of entity to be examined.
- · Results of previous examination.
- Objectives of the examination.
- Identification of the risks to be assessed.
- Scope of the examination/nature and depth of coverage.
- An overview of the branch's management structure.
- Summary of the branch's activities.
- Summary of earnings and other performance information to date.
- Summary of the structure and business strategy/plan of the branch.
- Balance sheet and contingency/memoranda items.
- · Administrative issues.

requirements.

- Allocation of assigned personnel resources.
- Business components and support functions.
- Workpaper and report of examination

DEVELOPING THE FIRST DAY LETTER

Once the scope memorandum is completed, the examiner-in-charge can develop the First Day Letter, which should be delivered to branch management in a timely manner, before the start of the examination. Upon presentation of the First Day Letter, the examiner should ensure that management understands what is being

requested and how to avoid duplication of effort through the use of information that may already be generated by the branch's own management information systems.

The examiner-in-charge must ensure that branch personnel are fully aware of how the information is to be prepared, when the information is required, and the need for accuracy and completeness.

A risk-focused review of a loan portfolio is one of the most important elements of an examination. Credit reviews are an examiner's primary means for evaluating the effectiveness of internal loan review and credit-grading systems, determining that credit is being extended in compliance with internal policies and credit standards, ascertaining a branch's compliance with applicable laws and regulations, and judging the safety and soundness of the branch's lending and credit administration functions. Examiners must select for review a sample of loans1 that is sufficient in size and scope to enable them to reach reliable conclusions about the branch's overall lending function. The specific details of selecting the sample is subject to the examiners's discretion, based on the level of risk perceived at the institution.

Sampling enables the examiner to draw conclusions regarding the condition of the entire loan portfolio and selected off-balance-sheet items by reviewing only a selected portion of outstanding credit facilities. Thus, such techniques economize on the use of examination resources and allow examiners to devote more of their time and efforts to other areas of examination interest.

Generally, a judgmental sampling technique is used for reviewing credit facilities. This technique enables examiners to evaluate the portfolio by reviewing a desired percentage of all loans and appropriate off-balance-sheet items over preselected cut-off amounts. In addition to the judgmental sampling approach, statistical sampling techniques can also be valid methods for evaluating credit portfolios. Two statistical sampling techniques that may be selectively implemented during on-site examinations are attribute sampling and proportional sampling. Attribute sampling is used in certain branches that have formal loan review programs; proportional sampling is used in branches without such internal credit review programs.

In statistical sampling, the examiner applies sampling techniques to the design, selection,

and evaluation of samples by employing the concepts of probability. Use of these concepts eliminates (or at least minimizes) biases by satisfying a condition that each item in the population must have an equal or otherwise determinable probability of being included in the examined portion. By satisfying that condition, statistical sampling provides the examiner with a quantitative measure of risk that can be controlled at a level that is tolerable to the examiner. Statistical sampling techniques may be implemented only in those branches that were found to be in financially sound condition at the latest examination and only in those branches where it is determined that the systems and controls are appropriate for implementing such techniques. Moreover, if during the examination where statistical sampling is being used, the examiner determines that the sample results are unsatisfactory or the condition of the branch has deteriorated since the previous examination, the traditional judgmental sampling technique must be implemented.

The following is a description of the two recommended statistical sampling techniques:

ATTRIBUTE SAMPLING

The objective of attribute sampling is to use a sample, within specified reliability limits, to determine the validity of the branch's internal credit review program. The reliability limits are determined by the examiner who formulates a hypothesis about the branch's credit review program when evaluating its policies, practices, and procedures with regard to extensions of credit. The sample population consists of all loans and appropriate off-balance-sheet items between certain dollar parameters, except for credit facilities reviewed under the Shared National Credit Program and facilities to identified problem industries, which are reviewed separately during the examination. The lower dollar parameter is an amount that the examiner deems sufficient to achieve the desired coverage of the portfolio and is selected in much the same manner as a cut-off line is chosen in judgmental sampling. The upper dollar parameter is an amount over which all credit facilities must be reviewed because of the significant effect each could have on the branch's condition. Credit

^{1.} For the purposes of this section, the term "loans" includes all sources of credit exposure arising from loans and leases including interbank placements, investment securities, and banker's acceptances. This exposure also includes credit-related off-balance-sheet items such as standby letters of credit, loan commitments, and risk participations in acceptances. Credit exposures arising from trading and derivatives activities are not generally included.

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facilities are selected from the sample population by using a random digit table.

When the selected credit facilities are reviewed, the examiner compares the findings with those of the branch's credit review program. An error exists if the examiner's criticism of a particular credit is significantly more severe than the branch's findings. If the error rate in the sample is beyond the reliability limits that the examiner is willing to accept, all credit facilities over the appropriate cut-off line will be reviewed. If the examiner is satisfied with the sample results, the branch's internal classifications may be accepted for all criticized loans within the sample population. Even when the branch's classifications are deemed acceptable by the examiner, any loans reviewed and found to be in error will be appropriately classified in the report.

PROPORTIONAL SAMPLING

Generally speaking, the procedures for proportional sampling are similar to those followed for attribute sampling. The examiner formulates a hypothesis about the quality of the examined branch's credit administration based upon an analysis of its loan policies, practices, and procedures with regard to extensions of credit. Additionally, the branch is asked to provide a problem credit list, without grading the credit facilities. The examiner's findings are compared to that list. The objective of this sampling

technique is to determine whether management can identify all the criticizable credit facilities in its portfolio. In proportional sampling, every credit in the sample population is given an equal chance of selection proportionate to its size; therefore, the larger the credit, the more likely it will be selected for review.

As in attribute sampling, the examiner specifies the desired precision of the sample, i.e., that the true error rate in the branch's problem credit list should be contained within a certain range of values. As a control measure, sample precision is set to represent a specified percentage of the branch's net assets. A statistical error occurs whenever the examiner criticizes a credit not previously identified by the branch. If the error rate is higher than expected, the examiner may review all credit facilities over selected cut-off lines, which are determined by using the same criteria used for line selection in judgmental sampling. If the sample results indicate an error rate within expectations, then the examiner may accept the branch's problem credit list as being representative of the quality of the population of credits from which the sample was taken. The examiner will then review each credit on the problem list over the selected cut-off lines to determine the amounts that should be classified.

For detailed procedures on how to implement both attribute and proportional sampling techniques, examiners should contact appropriate regulatory agency staff. Effective date July 1997

The primary goal of workpapers is to strengthen the examination process by providing a clear recounting of the many tasks performed during an examination. Workpapers, their purpose, their quality, and organization are important to the supervisory process because the workpapers support the information and conclusions contained in the related report of examination. Accordingly, they could include, but are not necessarily limited to: risk-focused scope memorandum (as discussed in section 2010), examination procedures and verifications, memoranda, schedules, questionnaires, checklists, abstracts of branch documents, analyses prepared or obtained by examiners, and a summary memorandum for each component. To this end, the workpapers should achieve the following objectives:

- Organize the material assembled during an examination to facilitate review and future reference:
- Aid the examiner in efficiently conducting the examination;
- Document the policies, practices, procedures, and internal controls of the branch;
- Provide written support of the examination procedures performed during the examination;
- Indicate why certain steps or procedures were eliminated or deemed unnecessary;
- Document the results of testing and formalize the examiner's conclusions; and,
- Substantiate the assertions of fact or opinion contained in the report of examination.

They also are useful as:

- A tool for the examiner-in-charge to use in planning, directing, and coordinating the work of the other examiners:
- A means of evaluating the quality of the work performed;
- A confirmation that the work recommended by the annual examination plan was performed as specified;
- A guide in estimating future personnel and time requirements; and
- A record of the procedures used by the branch to assemble data for reports to supervisory authorities.

WORKPAPER DOCUMENTATION

Each individual workpaper should include a workpaper coversheet, scope, and conclusion.

Workpaper Coversheet—A workpaper coversheet should provide the following information:

- Office name and location;
- · Workpaper title;
- Examination date and work performance date;
- Initials of preparer and initials of the assigned reviewer;
- Name and title of person or description of records that provided the information for the workpaper; and
- An index number identifying the workpaper and facilitating organization of the workpaper files.

Scope—This should address the activities performed in order to examine the particular area, including the nature, timing, and extent of testing in the application of examination and audit procedures as well as the examiner's evaluation of and reliance on internal and external audit procedures and compliance testing of internal controls. To the extent that this information is contained in other workpapers, such as the risk-focused scope memorandum, a reference to the appropriate workpaper will be sufficient. Because of the risk-focused nature of examinations, an explanation should be provided in the scope section of the workpapers explaining why the particular scope was chosen for a specific area or function. The workpapers also should contain an explanation as to why certain steps or examination procedures were eliminated or deemed unnecessary. This information is necessary in order to ensure that an effective audit trail is documented in the workpapers detailing the reasons for the scope chosen.

Conclusion—This summarizes the findings both positive and negative, and lists any recommendations made by examiners. Each workpaper summary is consolidated into the applicable component(s) rating conclusion memorandum.

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ORGANIZATION OF WORKPAPERS

To promote efficiency and help ensure that all applicable areas of an examination have been considered and documented, examiners should use an indexing system to organize workpaper files. A general outline or index of all examination areas provides a basis for organization to which a numbering or other sequential system can be assigned and applied to each workpaper file.

When all workpapers pertinent to a specific area of the examination have been completed, the workpapers should be indexed and filed by each rating component. A component rating conclusion memorandum is then prepared for each of the ROCA components. This memorandum should include a list of workpapers completed, a summary of findings and conclusions, a recommended rating for the component, and any required corrective action to be recommended in the report.

CONTROL AND REVIEW

All examiners assigned to an examination should ensure that workpapers are controlled at all times while the examination is in progress. For example, when in the branch's offices, the workpapers should be secured at night and safeguarded during the lunch hour or at other times when no examining personnel are present in the immediate vicinity. It is essential to completely control confidential information provided by the branch. In addition, information relating to the extent of tests and similar details of examination procedures should not be made available to branch employees.

In cases where customary workpaper procedures are not practical, alternative procedures and the extent to which they are applied should be documented. The need for completeness requires that there be no open items, unfinished operations, or unanswered questions in the workpapers at the conclusion of the examination.

The clarity of workpapers should be such that an examiner or examining official unfamiliar with the work could readily understand them. Commentaries should be legible, concise, and support the examiner's conclusions. Descriptions of work completed, notations of conferences with branch management, conclusions reached, and explanations of symbols used should be free from ambiguity or obscurity. In addition, examining personnel should be instructed on workpaper standards and content to ensure that they will meet the quality standards of the regulatory agencies. When workpapers have the necessary qualities of completeness, clarity, conciseness, and neatness, a qualified reviewer may easily determine their relative value in support of conclusions and objectives reached. Incomplete, unclear, or vague workpapers may lead a reviewer to the conclusion that the examination has not been adequately performed.

REVIEW PROCEDURES

Experienced personnel must review all workpapers prepared during an examination. Usually, that review is performed by the examiner-incharge, although in some cases, the examiner-in-charge may designate other experienced personnel to perform the review. The primary purposes of a review of workpapers by senior personnel are to determine that the work is adequate, given the circumstances, and to ensure that the record is sufficient to support the conclusions reached in the report of examination. The timely review and discussion of workpapers with the individual who prepared them is one of the more effective on-the-job training procedures.

Normally, the review should be performed as soon as practicable after the completion of each assignment. This review ideally occurs at the branch's office, so that, if additional information or work is required, the matter can be promptly attended to with a minimum loss of efficiency.

When the review of workpapers is completed, the reviewer should sign or initial the applicable documents. Although all workpapers should be reviewed, the depth and degree of review depends on factors such as:

- The nature of the work and its relative importance to the overall examination objectives.
- The extent to which the reviewer has been associated with the area during the examination.
- The experience of the examiners who have carried out the various operations.

Examiner judgment must be exercised throughout the review process.

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WORKPAPER RETENTION

Examiners should consult with their respective agency for further guidance on workpaper retention guidelines.

Effective date July 1997

Supervisory follow-up actions are implemented to ensure that appropriate corrective actions are taken in a timely manner to resolve any supervisory concerns that exist with respect to a branch. Generally, supervisory action is initiated based upon the results of an on-site examination. Action may be initiated, however, in response to concerns developed through various supervisory monitoring programs or through the review of other available information.

Because branches are subject to supervision by their federal or state licensing authority, branches may be subject to supervisory follow-up actions by all of these supervisory authorities. In most cases, however, if concerns are limited to one branch of the foreign banking organization, supervisory follow-up action will be the responsibility of the examining agency or agencies. If problems are apparent in other branches of the foreign banking organization, the various supervisory authorities will coordinate the development of the supervisory action plan for the institution.

INFORMAL AND FORMAL SUPERVISORY ACTIONS

As a general rule, informal and formal supervisory action should be considered when normal follow-up procedures and other more routine measures, such as formal discussions with a branch's local or head office management, have failed to resolve supervisory concerns. This practice is consistent with the treatment of domestic banking organizations and is based on the expectation that all banking institutions operating in the United States are expected to operate in a safe and sound manner and in compliance with applicable U.S. laws and regulations. Accordingly, when supervisory concerns are identified, corrective action should be initiated by branch or head office management as soon as possible. In this regard, examiners should communicate to the management of the branch throughout the course of the examination and at its close, both the problems identified and the actions recommended to correct those problems.

Generally, an informal supervisory action is appropriate when supervisory concerns have been identified that, while not overly serious in nature, do warrant some type of remedial action undertaking with the foreign banking organization. Such concerns may be isolated in one branch or may be evident in other branches of the foreign banking organization. In either case, the action is entered into with the foreign banking organization and the affected U.S. branch or branches; it involves a mutually agreed upon understanding between the foreign banking organization and the supervisory agency or agencies. The action generally lists and describes how specific objectives are to be achieved, including timeframes for achieving those objectives.

Informal enforcement actions that may be utilized for branches include the Commitment Letter and the Memorandum of Understanding.

A Commitment Letter is a document that contains specific written commitments to take corrective action in response to problems or concerns identified by the supervisory agency or agencies. A Commitment Letter is not a binding legal document; however, failure to meet the commitments in the letter will provide strong evidence of the need for more formal supervisory action.

A Memorandum of Understanding is a more formally designed action, though still not a binding legal document, that incorporates even greater specificity concerning the measures being taken to resolve problems than found in a Commitment Letter. A Memorandum of Understanding suggests a higher level of supervisory concern over that of a Commitment Letter. It generally must be signed by senior officials from the head office.

Formal supervisory actions are appropriate in instances where supervisory concerns have risen to a level where stronger or more immediate action is necessary to ensure that corrective actions are taken and fully implemented. These actions are authorized by statute and noncompliance has a legal liability, i.e. violators can be subject to additional enforcement actions, such as the assessment of civil money penalties.

Formal enforcement actions include the Cease and Desist Order, including a Temporary (Emergency) Cease and Desist Order, and the Written Agreement. Cease and desist action may be initiated when there is a finding that an offender is engaging, has engaged, or may engage in an unsafe or unsound practice in conducting the business of the institution. An action may also

be deemed necessary due to a finding that the offender is violating, has violated, or may violate a law, rule, or regulation, or any condition imposed in writing, for example, by the Board of Governors in connection with the granting of any application or written agreement.

In the event that a violation of law, rule, or regulation, or the undertaking of an unsafe or unsound practice meets certain criteria, a temporary (emergency) cease and desist order may be issued. This order may also be issued if it is determined that the institution's books and records are incomplete or that the institution's financial condition or the details or purpose of any transaction cannot be determined through the normal supervisory process. The temporary order may require the same corrections as an order issued either on consent or after the full administrative process. Its advantage is that it is effective immediately upon service on the entity or individual. A hearing must be held within 30–60 days, during which time the temporary order stays in effect. Within 5-10 days of the service of the temporary order, the subject may appeal to a U.S. District Court for relief from the order.

When circumstances warrant a less severe form of formal supervisory action, a *formal written agreement* may be used. Other enforcement tools that are applicable to branches include the imposition of civil money penalties, prohibition orders, and possibly termination.

CIVIL MONEY PENALTIES

Under provisions of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FICA) (Pub. L. 95-630), the appropriate federal banking agency is authorized to assess civil money penalties for violations of any law or regulation or for violation of the terms of any written agreement, any final or temporary cease and desist order or any condition imposed in writing by a federal banking agency in connection with the granting of any application by the foreign banking organization. Civil money penalties may also be imposed, in certain cases, for engaging in unsafe and unsound practices (12 USC Section 1818). In addition, civil money penalties may be assessed against officers, directors, and other institution-affiliated parties for violations of any of the above situations.

In determining the appropriateness of initiating a civil money penalty assessment proceeding, the federal banking agencies may use a variety of relevant factors. For example, in assessing a civil money penalty, the Board of Governors is required to consider the size of the financial resources and good faith of the respondent, the gravity of the violation, the history of previous violations and such other matters as justice may require. (See FRRS, Section 3-1605.) Other regulatory agencies have their own guidelines. (See, for example, *OCC Policy and Procedures Manual.*)

Depending upon the regulatory agency involved, examiners may be responsible for the initial analyses of potential civil money penalties. Civil money penalties may be proposed for serious violations and for violations that, because of their frequency or recurring nature, show a general disregard for the law. After the examiner has reviewed the facts and decided to recommend a civil money penalty, he or she should contact the appropriate federal regulatory agency for advice on proper documentation and any other assistance.

ASSET MAINTENANCE

In cases where there is doubt concerning the ability of a foreign banking organization to continue to serve as a source of strength to its U.S. branch(es), supervisory action may have to be taken to safeguard the U.S. branch(es) and ensure that it can honor its liabilities to third parties. Under these circumstances, an asset maintenance requirement¹ of at least 105 percent material may be imposed on the individual branch.

Other actions that may be taken to address concerns of this nature regarding the foreign banking organization include: asset pledge requirements, increased capital equivalency deposits, restrictions on transactions with related

^{1.} Asset maintenance means the maintenance of eligible assets in the United States covering a specified percentage of third party liabilities of a branch. In general, eligible assets are those for which there is a reasonable expectation of liquidation on a timely basis. When under an asset maintenance requirement, a branch must maintain a net due to related parties position at all times. Thus, the branch is prevented from providing net funding to other branches or the head office. For more specific information on the examination objectives and procedures relating to asset maintenance, refer to that section of the manual.

parties, funding limitations, growth limitations, and voluntary or involuntary termination of the branch.

In some cases, because of concerns about the financial condition of the foreign banking organization or circumstances in the home country that may adversely affect the foreign banking organization's U.S. operations, asset maintenance may be necessary even when the U.S. operations are in satisfactory condition. When the U.S. operation are in less than satisfactory condition, the severity of the problems in those operations, combined with the degree of concern over the solvency of the foreign banking organization, will be used to determine the appropriate com-

bination of informal or formal supervisory action and asset maintenance requirement.

When an asset maintenance requirement is deemed necessary, the preferred way to implement such a requirement is by action of the appropriate licensing agency and the insurer through any means available, including mutual agreement, authorization under state law, or formal supervisory action. Asset maintenance may therefore be imposed regardless of whether it is a specific regulatory tool of the licensing authority. When multiple branches are involved, as a general principle, asset maintenance requirements will be defined to be applied in a consistent manner to all of the operations of the foreign banking organization.

Section 3000.1

Taking and managing risks are fundamental to the business of banking. The U.S. banking supervisory agencies place significant emphasis on the adequacy of an institution's management of risk, including the establishment of a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business. In a branch, which is typically removed from its head office by location and time zone, an effective risk management system is critical not only to manage the scope of its activities but to achieve comprehensive, ongoing oversight by branch and head office management. In the examination process, examiners will therefore determine the extent to which risk management techniques are adequate (1) to control risk exposures that result from the branch's activities and (2) to ensure adequate oversight by branch and head office management and thereby promote a safe and sound banking environment.

Principles of sound management should apply to the entire spectrum of risks facing a branch including, but not limited to, the following:

- Credit risk which arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- Country/transfer risk which encompasses the entire spectrum of risks arising from the economic, social and political environments of a foreign country which may have potential consequences for foreigners' debt and equity investments in that country. More specifically, transfer risk focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt.
- Market risk which is the risk to a financial institution resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
- Liquidity risk which is the potential that a
 branch will be unable to meet its obligations
 as they come due because of an inability to
 liquidate assets or obtain adequate funding
 (referred to as "funding liquidity risk") or that
 it cannot easily unwind or offset specific
 exposures without significantly lowering market prices because of inadequate market depth
 or market disruptions ("market liquidity risk").

- Operational risk¹ which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- Legal risk which arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of the branch.
- Reputational risk which is the potential that negative publicity regarding a branch or its parent bank will cause a decline in the customer base, costly litigation, or revenue reductions.

ELEMENTS OF RISK MANAGEMENT

When rating the quality of risk management at branches, examiners should place primary consideration on findings relating to the following elements of a sound risk management system:

- active senior management oversight at the head office, regional management office (if applicable) and local branch levels;
- adequate policies, procedures, and limits; and
- a strong management information system for measuring, monitoring and reporting risks.

Each of these elements is described further below, along with a list of considerations relevant to assessing the adequacy of each element.

Examiners should recognize that the considerations specified in these guidelines are intended only to assist in the evaluation of risk management practices and not as a checklist of requirements for each branch.

Adequate risk management programs can vary considerably in sophistication, depending on the size and complexity of the FBO and its branch network and the level of risk that it accepts. Examiners need to ensure that senior managers

^{1.} While operational, legal and reputational risks are identified as part of the branch's overall risk assessment process, the effectiveness of the branch's operational controls are included in the "O" component of the ROCA rating system assessment. Further, when legal and reputational risks potentially result in violations of law or regulation, the "C" component would also be impacted.

at the head office and/or at the regional management office are provided with the information they need to monitor and direct day-to-day activities of the branch.

The risk management processes of branches would typically contain detailed guidelines that set specific prudential limits on the principal types of risks relevant to the FBO's activities worldwide. Reporting systems should comprise an adequate array of reports that provide the levels of detail about risk exposures that are relevant to the duties and responsibilities of senior management at the head office and, where applicable, the regional management office.

The risk management systems will naturally require independent monitoring and testing in addition to review by internal or external auditors to ensure the integrity of the information used by senior officials in overseeing compliance with policies and limits. The risk management systems or units of FBOs must also be sufficiently independent of the business lines in order to ensure an adequate separation of duties and the avoidance of conflicts of interest.

ACTIVE HEAD OFFICE SENIOR MANAGEMENT OVERSIGHT

As part of its responsibility to provide a comprehensive system of oversight for the branch, the head office has a role in developing and approving a risk management system for the branch. Senior management at the head office, regional management office and local branch levels are responsible for implementing strategies in a manner that limits risks associated with each strategy, and that ensures compliance with laws and regulations on both a long-term and day-to-day basis. Accordingly, branch management should be fully involved in the activities of the branch and possess sufficient knowledge of all major business lines to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated. Management is also responsible for establishing and communicating a strong awareness of and need for effective internal controls and high ethical standards.

In assessing the quality of the oversight by head office, regional and branch management, examiners should consider whether the branch follows policies and practices such as the following:

- Management has identified and clearly understands the types of risks inherent in the activities of the branch and makes appropriate efforts to remain informed about these risks as financial markets, risk management practices, and the branch's activities evolve. Management periodically reviews risk exposure limits to ensure they are appropriate considering changing circumstances.
- Management has reviewed and approved appropriate policies to limit risks inherent in all significant activities of the branch, including lending, investing, trading, private banking, and trust.
- Management is sufficiently familiar with and is using adequate recordkeeping and reporting systems to measure and monitor the major sources of risk to the branch.
- Management ensures that the branch's areas of activities are managed and staffed by personnel with knowledge and experience consistent with the nature and scope of these activities.
- Management ensures that the depth of staff resources is sufficient to operate and manage the activities of the branch and that branch employees have the necessary integrity, ethical values, and competence.
- Management at all levels provides adequate supervision of the day-to-day activities of all employees, including senior officers.
- Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the branch is active.
- Management identifies and reviews all risks associated with new activities or products and ensures that the branch infrastructure and internal controls in place are adequate to manage related risks prior to commencing new activities or offering new products.

ADEQUATE POLICIES, PROCEDURES AND LIMITS

Head office management should tailor risk management policies and procedures to the types of risks that arise from the activities the branch conducts. Once the risks are properly identified, the branch's policies and procedures provide

detailed guidance for the day-to-day implementation of broad business strategies, and generally include limits designed to shield the branch from excessive or imprudent risks. While all branches should have policies and procedures that address significant activities and risks, the coverage and level of detail in these policies and procedures will vary among branches. A smaller, less complex branch that has effective management that is actively involved in day-to-day operations generally would be expected to have only basic policies addressing the significant areas of operations and setting forth a limited set of requirements and procedures. In a larger branch, where senior management must rely on widely-dispersed staff to implement strategies in an extended range of potentially complex businesses, far more detailed policies and related procedures would generally be expected. In either case, management is expected to ensure that policies and procedures address the material areas of risk to the FBO and the branch and that they are modified when necessary to respond to significant changes in the branch's activities or business conditions.

In evaluating the adequacy of a branch's policies, procedures and limits, examiners should consider whether:

- The branch's policies, procedures and limits provide for adequate identification, measurement, monitoring and control of the risks posed by lending, investing, trading, private banking, trust and other significant activities.
- The branch's policies, procedures and limits are consistent with the experience level, stated goals and objectives, and overall financial strength of the organization.
- Policies clearly delineate accountability and lines of authority across the branch's activities.

EFFECTIVE RISK MONITORING AND MANAGEMENT INFORMATION SYSTEMS

Effective risk monitoring requires branches to identify and measure all risk exposures. Consequently, risk monitoring activities must be supported by information systems that provide senior managers at the head office, regional office, and

branch with timely reports on the financial condition, operating performance, and risk exposure of the consolidated organization, as well as with regular and sufficiently detailed reports for line managers to engage in the day-to-day management of the branch's activities.

The sophistication of the risk monitoring and management information systems should be consistent with the complexity and diversity of the branch's operations. Accordingly, smaller and less complicated branches may require only a limited set of management reports to support risk monitoring activities. These reports include, for example, daily or weekly balance sheets and income statements, a watch list for potentially troubled loans, a report for past due loans, a simple interest rate risk report, and similar items. Larger, more complex branches, however, would be expected to have much more comprehensive reporting and monitoring systems that allow, for example, for more frequent reporting, tighter monitoring of complex trading activities, and the aggregation of risks on a fully consolidated basis across all business lines and activities. Branches of all sizes are expected to have risk monitoring and management information systems in place that provide senior management with a clear understanding of the branch's positions and risk exposures.

In assessing the adequacy of the measurement and monitoring of risk as well as management reports and information systems at a branch, examiners should consider whether:

- The branch's risk monitoring practices and reports address all risks.
- Key assumptions, data sources, and procedures used to measure and monitor risk are appropriate, adequately documented and periodically tested.
- Reports and other forms of communication are consistent with the activities of the branch, are structured to monitor exposures and compliance with established limits, goals and objectives, and, as appropriate, compare expected to actual performance.
- Reports to head office are accurate and timely and contain sufficient information for senior management to identify any adverse trends and to evaluate the level of risk assumed by the branch.

CREDIT RISK

This section is devoted to credit risks associated with direct lending arrangements. The comprehensiveness of a credit risk management system will depend upon the sophistication and types of credit-related activities being conducted by the branch. In some circumstances, a branch may have no independent lending authority and may simply serve as a booking office for loans approved by the head office. A more active branch may, however, have an independent credit review department and established lending authorities. Therefore, credit policies, procedures, and documentation may vary significantly.

This section will assist the examiner in performing two separate, but interrelated, procedures:

- The evaluation of the depth and scope of formalized policies and procedures used by the branch to manage and control its credit risks.
- An overview of the performance of the branch's entire lending operations by evaluating the results of all lending departments.

Branch Credit Administration Policies

As part of the analysis of a branch's loan portfolio, examiners review credit policies, credit administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation is essential to the institution's management of the lending function.

The policies and procedures governing a branch's lending activities must be clearly communicated to management and lending staff. These policies and procedures must define prudent underwriting standards, credit risk controls, prudent internal limits, and an effective credit review and risk identification process. The complexity and scope of these policies and procedures should be appropriate to the size and nature of the branch's activities, and should be consistent with prudent banking practices and applicable federal and state laws and regulations.

The establishment of a written lending policy provides the foundation for sound loan portfolio

management. Throughout this manual there is considerable emphasis on the establishment of formal written policies to guide and manage the scope of the branch's activities within acceptable risk parameters, and to achieve comprehensive, ongoing oversight by branch and head office management. This is perhaps the most important element in the branch lending function. The banking organization, in discharging its duty to both the depositors and shareholders, must ensure that loans in the branch portfolio are made in accordance with the following two objectives:

- To grant loans to creditworthy borrowers for constructive purposes.
- To grant loans that generate income for the benefit of shareholders and the protection of depositors, and in the case of branches, the protection of third parties.

A loan policy will differ from loan procedures. Branches need both to adequately address all areas of lending and loan administration. The lending policy should contain a general outline of the scope of the branch's credit facilities and the manner in which loans are made, serviced, and collected. The policy should be broad in nature and not overly restrictive. The formulation and enforcement of inflexible rules not only stifles initiative but also may hamper profitability and prevent the branch from serving customers' changing needs. A lending policy should provide for the presentation to the head office or a committee thereof, of loans that credit officers believe are fundamentally sound and worthy of consideration, even though they may not conform with certain aspects of the branch's written lending policy. Any exceptions to the lending policy should be approved, documented, monitored and reported to head office. Flexibility must exist to allow for fast reaction and early adaptation to changing conditions in the branch's earning assets mix and within its service area.

The written loan policy is the cornerstone for sound lending and loan administration. An adequate loan policy serves to promote:

- Consistency in business and lending philosophy, despite changes in management.
- Stability as it provides a reference for lending authorities.

- Clarity to minimize confusion concerning lending guidelines.
- Objectivity as it provides sound guidelines for evaluating new business opportunities.

In developing the lending policy, consideration must be given to the branch's business plan, financial resources, and personnel. Typically, a branch's lending policy will be used to describe the branch's mission statement, e.g., facilitating trade transactions with the home country and lending to U.S. subsidiaries of home country corporations.

A lending policy should prohibit discriminatory practices. However, a policy should identify acceptable and unacceptable types of credit and establish prudent underwriting standards, including pricing standards. Other internal factors addressed include granting credit authority, establishing lending limits, and defining organizational structure. As authority is spread throughout its offices, the organization must have an effective method for monitoring adherence to established policy. The testing of credit quality standards can best be accomplished by an internal loan review and reporting function to the head office, which allows senior head office management to monitor adherence to policies and provides information sufficient to evaluate the performance of branch officers and the condition of the loan portfolio. The audit function can also serve to enforce compliance with policies, guidelines, and approved credit administration practices.

Components for a Sound Lending Policy

The lending policy should require diversification within the portfolio and provide prudent underwriting standards. There are certain components that form the basis for a sound loan policy and should be addressed by every lending institution.

Aggregate Limits and Distributions by Category—In order to limit the total amount of loans outstanding, relationships with other balance sheet accounts should be established. Branches usually express controls over the loan portfolio relative to their total claims on nonrelated parties. In setting such limits, various factors, such as credit demand, legal lending

limit, borrower or industry concentration, the volatility of funding and the credit risks involved must be considered. Additionally, limits on aggregate percentages of total loans in commercial, real estate, consumer, or other categories are common. Such policies are beneficial but should allow for deviations with the approval by the head office. This allows credit to be distributed in relation to the changing needs of the target markets.

Geographic Limits—A branch's trade area should be clearly delineated and loan officers and senior management should be fully aware of specific geographic limitations for lending purposes. Although many branches will define their trade areas to include a number of states, frequently, the primary calling efforts are focused on a narrower area. Certain types of lending, which require significant knowledge of local market conditions or intensive monitoring of branch personnel, should be carefully considered. Examples include commercial loans to large regional companies, loans to finance commercial real estate projects, or asset based lending that requires regular monitoring of accounts receivables. In addition, the branch's defined trade area should not be so large that, given its resources, proper and adequate monitoring and administration of the branch's credits cannot be reasonably determined.

Concentrations of Credit—The loan policy should recognize the need for diversification of risk and establish some parameters on concentrations of loans to industries, related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry.

Examiners should recognize that as a part of a larger banking entity, individual branches may have concentrations that are well within proper diversification in the context of the overall organization. Many branches specialize in terms of the kind of business transacted and the types of credits extended. Many credits are traderelated and often reflect the economic makeup of the branch's home country. In addition, credits at the branch are often booked at the direction of the head office and can reveal concentration by industry, country, or borrower. Nonetheless, branches, as part of a sound risk management system, must establish procedures for identify-

ing and monitoring inherent risk resulting from concentrations of credit.

Institutions that have effective controls in place to manage and reduce undue concentrations need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location. It is important to emphasize that this principle applies to loan renewals, rollovers, and new extensions of credit.

Types of Loans—The lending policy should state the types of loans that the branch will make and should set forth guidelines to follow in making specific loans. The decision about the types of loans to be granted should be based on a consideration of the business plan, expertise of the lending officers and support personnel, the funding structure of the branch, and anticipated credit demands of the target markets. Credits involving complex structures or repayment arrangements or loans secured by collateral that require more than normal policing should be avoided unless or until the branch obtains the necessary personnel, policies, controls, and systems to properly administer such loans. Types of credits that have resulted in an abnormal loss to the branch should be identified, scrutinized, and controlled within the framework of stated policy.

Repayment Terms and Maximum Maturities— Loans should be granted with realistic repayment plans. Maturity scheduling should be related to the anticipated source of repayment, the purpose of the loan, and the useful life of the collateral. For term loans, a lending policy should state the maximum number of months over which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modification of the original terms of a loan. If the branch requires a cleanup (out-of-debt) period for lines of credit, the period should be explicitly stated.

Loan Pricing—Rates on various loan types established by the loan policy must be sufficient to cover the costs of the funds loaned, of servicing the loan, including general overhead and of probable losses while providing for a reasonable margin of profit. Policy makers must know those costs before establishing rates that arise out of an effective risk management process. Periodic review allows the rates to be adjusted to reflect changes in costs, competitive factors, or the risks associated with the type of extension of credit. Specific guidelines for other

relevant factors, such as commitment fees, are also germane to pricing policy.

Documentation and Collateral—Trade financing often represents a significant amount of the branch's lending activity. In such financing, the branch deals only in documents while its customer is responsible for the merchandise under the terms of the contract. The branch's control of documents, especially title documents, is crucial. There are significant differences between domestic loan agreements and foreign ones. Nevertheless, the branch must ensure that it is adequately protected through loan agreements with foreign borrowers. The loan agreement should also protect against adverse changes in foreign tax rules, loan funding problems, and additional withholding and other types of taxes. The branch should have policies for taking foreign collateral as security for a loan to assure adherence with the local required procedures. For example, liens on fixed assets in many countries must be registered with the local government.

Maximum Ratio of Loan Amount to Collateral Value or Acquisition Costs—The branch's lending policy should identify where the responsibility for appraisals or internal evaluations lies and should define formal, standard appraisal, and evaluation procedures, and procedures for possible reappraisals or reevaluations in the case of renewals or extensions. Acceptable types of appraisals or evaluations should be listed. The policy should also include the limits on the dollar amount and type of real or personal property that branch personnel are authorized to appraise. Circumstances regarding the use of in-house appraisers versus a fee appraiser should be identified. The ratio of loan amount to the value of the collateral, the method of valuation, and the differences for various types of property should be detailed.

Financial Information—Extending credit on a safe and sound basis depends on complete and accurate information regarding the borrower's credit standing. One exception is when the loan is predicated on readily marketable collateral, the disposition of which was originally designated as the source of repayment for the advance. Current and complete financial information is necessary not only at the inception of the credit but also throughout the term of the credit. The lending policy should define the requirements of

financial statement information for various types of credit extended by the branch. In addition, the lending policy should define the requirements for financial statements and operating data for businesses and individuals at various borrowing levels and should include requirements for audited, non-audited, annual, interim, income, cash flow and other financial statements, tax returns, changes in owner's equity and other supporting notes, schedules, and management analyses. Financial statement requirements should include external credit checks required at the time of periodic updates. The policy should define the financial requirements in such a manner that any credit data exception in an examination report should be a clear contravention of the branch's lending policy.

Financial statements for foreign borrowers or guarantors may present additional risks or problems not associated with domestic borrowers. Foreign customers' financial statements may be prepared in either U.S. dollar equivalents or in the borrower's local currency. Most branches analyze the latter statements, particularly if that currency is unstable, therefore figures stated in U.S. dollar equivalent amounts would be distorted by the conversion rates used at various times. Sometimes, the branch may need to reconstruct a borrower's financial statement in U.S. dollar equivalents to reflect the borrower's financial strength and weaknesses more accurately. Since the financial information may not be reliable, the branch's policies should enable it to determine by other means the capacity, integrity, experience and reputation of the foreign borrower. While analyzing foreign borrowers' financial statements, examiners should take into consideration the differences in foreign accounting practices from the generally accepted accounting principles (GAAP) in the United States.

Limits on Country Exposures—The loan policy should define maximum exposures to countries other than the United States. All sizeable exposures should be supported by country analyses and other supporting information. Country limits should be consistent with the creditworthiness of the respective countries.

Limits and Guidelines for Purchasing and Selling Loans Either Directly or Through Participations or Swaps—If sufficient loan demand exists, lending within the branch's trade area is safer and less expensive than purchasing paper from another bank. Direct lending promotes customer relationships, serves the credit needs of customers, and develops additional business. In some instances, however, a branch may not be able to make a loan to a customer for the full amount requested because of prudential lending limitations or other reasons. In such situations, the branch may extend credit to its customer for the full amount needed and sell or participate out that portion that exceeds the branch's lending limit or the amount it wishes to extend on its own. Generally, such sales arrangements are established before the credit is ultimately approved. These sales should be on a nonrecourse basis to the branch and the originating and purchasing institutions should share in the risks and contractual payments on a pro rata basis. Selling or participating out portions of loans to accommodate the credit needs of customers promotes goodwill and enables a branch to retain customers who might otherwise seek credit elsewhere.

Conversely, many branches purchase loans or participations in loans originated by other organizations. The policy should require that loans purchased from another source be evaluated in the same manner as loans originated by the branch itself. Generally, the branch should avoid concentrations in purchasing loans from any one outside source or concentrations in purchases of loans to any one industry.

Purchasing and selling loans can have a legitimate role in a branch's asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities can assist a branch in diversifying its risks and improving its liquidity.

The policy should state the limits for the aggregate amount of loans purchased from and sold to any one outside source and for all loans purchased and sold. Limits should also be established for the aggregate amount of loans to particular types of industries that may be purchased. Guidelines should be established for the type and frequency of credit and other information that should be obtained from the lead institution in order to keep the branch continually updated on the financial condition of the borrower and the status of the credit. Because of the inherent reliance on the lead institution to administer and collect participated loans, the purchasing branch should evaluate the lead institution's ability to properly carry out these responsibilities. Conversely, guidelines should also be established for supplying complete and regularly updated credit information to the purchasers of loans originated and sold by the branch.

Loan Authority—The lending policy should establish limits for all lending officers. In many branches of FBOs, most lending authority remains with the head office. If lending policies are clearly established and enforced, individual officer limitations may be somewhat higher, based on the officer's experience and tenure with the branch. Frequently, group lending limits are set, allowing a combination of officers or a committee to approve larger loans than the members would be permitted to approve individually. The reporting procedures and the frequency of committee meetings should be defined.

Collections, Charge-Offs, and Specific Reserves—The lending policy should define delinquent obligations and contain guidelines for placing loans on nonaccrual status and initiating foreclosure proceedings. Delinquency status is determined by the contractual terms and defined as when the principal or interest on an asset becomes due and unpaid for 30 days or more. For regulatory reports, branches must comply with the reporting requirements for past due and nonaccrual loans. Additionally, the policy should dictate the appropriate reports to be submitted to the head office concerning those obligations. The reports should include sufficient detail to allow for the determination of the loss potential and alternative courses of action. The policy should require a follow-up collection notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the head office for chargeoffs or specific reserves in accordance with applicable regulatory policy.

Legal Lending Limits—The lending policy may describe limitations on loans to one borrower, as are consistent with head office and/or federal requirements. The Foreign Bank Supervision Enhancement Act of 1991 superseded state legal lending limits to the extent that exposures to a single borrower by all state and federal branches of the same FBO must be aggregated and applied against the capital of the FBO (12 USC 84.)

Other—The lending policy should be supplemented with other written guidelines for specific

departments of the branch. Written policies and procedures approved and enforced in various departments should be referenced in the general lending policy of the branch.

Management should establish appropriate policies, procedures, and information systems to ensure that the impact of the branch's lending activities on its interest rate exposure is carefully analyzed, monitored, and managed. In this regard, consideration should also be given to the risks associated with off-balance sheet instruments related to lending arrangements, such as loan commitments and swaps.

Approval Process

In addition to the components that form the basis for a sound lending policy, there should be a documented approval process for exceptions to that policy, including the need for approval of exceptions by the head office. Management information systems should report and highlight loan exceptions to branch management and the head office.

Before a branch extends credit, its objectives, policies, and practices must be clearly established. Before examining a loan department, those objectives, policies, and practices should be reviewed by the examiner to determine if they are reasonable and adequate to properly supervise the portfolio. The absence of written guidelines is a major deficiency in the lending area and may indicate that the branch is not being properly supervised by its head office. The various credit extending areas should be examined to determine compliance with objectives, policies, and practices, which is a prime examination objective.

Loan Information Systems

The loan information system should include the loan policy and loan administration procedures, loan documentation maintained for borrowers, reports prepared for the benefit of senior management at the branch or at the head office, the loan grading and loan review system, and the system to manage problem loans.

Loan information and documentation should demonstrate that the borrower has the ability and willingness to repay the loan. These documents should also indicate that the lending officer has adhered to sound lending practices, acted prudently to safeguard the branch's funds, and ensured repayment of the loan by all reasonable means. Loan information and other documentation supporting an extension of credit should be in English to enable the examiner to properly evaluate the quality of the credit.

In general, loan documents should provide answers to the following questions:

- Who is the borrower, including ownership and affiliations?
- · How did the borrower come to the branch?
- What is the borrower's business?
- What is the purpose of the credit?
- What are the primary and secondary sources of repayment?
- What is the borrower's financial condition?
- What are projections for the borrower's future financial performance?
- How has the borrower performed on other credit obligations?
- What is the collateral for the loan, its location, value, and condition?

If guarantees are involved, the branch must have sufficient information on the guarantor's financial condition. Income, liquidity, cash flows, contingent liabilities, and other relevant factors should be evaluated, including credit ratings, when available, to demonstrate the guarantor's financial capacity to fulfill the obligation. Generally, however, loan quality should be evaluated based on the primary source of payment not secondary sources, such as guarantees. In this respect, guarantees from head office are not viewed as providing support to a loan.

An effective system to obtain and maintain complete and current loan information and documentation is a necessary component of sound lending. Failure to establish and enforce this system will increase credit risk and cause the branch to suffer losses that could have been avoided.

Before the loan is funded, the branch must ensure that all the required documentation is current. It is generally easier to ensure complete and current documentation before the loan is funded, as the borrower will be cooperative and the loan has the lending officer's full attention.

To ensure on-going attention to documentation, the loan policy should require the branch to obtain and maintain current documentation on borrowers and collateral. The loan policy should also ensure that loan documentation is reviewed periodically and any exceptions are addressed promptly.

INTERNAL LOAN REVIEW

Key Loan Review Objectives

Depending on the branch's size, its lending activities, and management philosophy, loan review may be handled by a part-time person, one person, an independent contractor, or a separate department staffed by a number of employees at the branch, at a regional U.S. office, or at the head office. An important ingredient of loan review is that it must be independent from the approval process. Regardless of how loan review is structured, a satisfactory loan review system should have the following objectives:

- · Provide an objective grading system for loans.
- Provide current information regarding portfolio risk to branch management and the head office on a timely basis.
- Identify problem credits and place them under additional scrutiny.
- Assist in the evaluation of the adequacy of specific and general reserves in accordance with applicable regulatory policy.¹
- Evaluate trends in the loan portfolio.
- Cite loan policy exceptions and noncompliance with procedures.
- Cite documentation exceptions.
- · Cite violations of laws and regulations.
- Assist in the development and revision of policy and procedures.
- Act as an information source concerning emerging trends in the portfolio and the branch's lending areas.

Loan Review Reporting

Loan review reporting must be thorough, accurate, and timely to provide sufficient information to allow management and the head office to both

Branches are not required to maintain an allowance for loan losses for Federal Reserve supervisory purposes. However, it is recognized that the licensing and insuring authorities may require U.S. branches to maintain such reserves under their respective jurisdictions to fulfill the requirements of their individual licensing or insurance statutes, or to satisfy other specific concerns of the authority.

identify and control risk. At a minimum, there should be three types of reporting required from loan review: file memoranda, head office reports, and an annual schedule or loan review plan.

File memoranda are completed after each loan is reviewed and are placed in the credit file to document the reviewer's conclusions. Loan grades and supporting facts should be included, along with any instances of noncompliance with the branch's policy, procedures and applicable regulations. Documentation exceptions should also be indicated.

If the process is conducted by the lending officers themselves, then compliance with policies and procedures is best determined by another branch department, such as internal audit.

Head office/management reports are summaries of the loan reviewer's conclusions regarding the quality of the portfolio or segment of the portfolio. These reports should state the scope of the review; the distribution of loan grades for the portfolio or segment of the portfolio; the percentage of both collateral and financial documentation exceptions; all instances of noncompliance with policies, procedures, or regulations; an assessment of the overall quality of the portfolio; and the resulting impact on the allowance for loan losses, where applicable, and any other factors that might have an adverse effect on the portfolio.

These reports should go to head office management. If applicable, a copy of these reports can also be given to U.S. regional management, the manager of the loan department, and the branch's executive management; however, management should not be allowed to influence the content of the report. The head office should be given this report on a timely basis and require lending officers to correct and respond to all significant problems and exceptions within a specified time frame.

Although a good loan review system is important to ensure sound lending and strong loan administration, excessive reliance should not be placed on this system. It is always the lending officers' responsibility to maintain sound underwriting standards and loan quality. It is also their responsibility to monitor the portfolio on an ongoing basis and to initially identify problem credits. Loan review should not be the first line of defense to identify emerging problems. Its primary responsibility is to identify weaknesses in lending and loan administration and their underlying causes.

Loan Problems

The failure of branch and head office management to establish a sound lending policy, to establish adequate written procedures, and to monitor and administer the lending function within established guidelines may result in substantial problems for the branch. Loan problems may be caused by a number of factors affecting the branch or its borrowers, such as the following:

Anxiety for Income—The loan portfolio is usually the branch's most important revenue producing asset. However, the pursuit of earnings must never be permitted to override sound underwriting principles by extending credit that carries undue risks or unsatisfactory repayment terms. Over the long term, unsound loans usually cost far more than the revenue they produce.

Compromise of Credit Principles—Branch management, for various reasons, may knowingly grant loans carrying undue risks or unsatisfactory terms in violation of its own underwriting standards. These reasons may include head office relationships with associated companies of the branch's customer. Self-dealing, anxiety for income, inappropriate salary incentives, bonuses based on loan portfolio growth, and competitive pressures may also lead to a compromise of sound credit principles.

Incomplete Credit Information—Character and capability may be determined by many means but complete credit information is the only acceptable and reasonably accurate method for determining a borrower's financial condition. The lack of sufficient financial information is an important cause of problem credits. Current and complete comparative financial statements, operating reports, and other pertinent statistical support should be available. Other essential information, such as the purpose of the borrowing, the intended plan and source of repayment, progress reports, inspections, and memoranda of outside information and loan conferences, should be contained in the branch's credit files. Proper credit administration and accurate credit appraisals are not possible without such information.

The Interagency Policy on Documentation of Loans by U.S. Branches and Agencies of Foreign Banks, which was issued on May 14, 1993,

exempts these branches from certain documentation requirements for credits to small and medium-sized businesses and farm loans. (Refer to the policy statement for specific limitations.)

Failure To Obtain or Enforce Repayment Agreements—Loans granted without a clear written agreement governing repayment violate a fundamental banking principle that frequently is a major cause of problem loans. Another common cause of problem loans is when scheduled payments or reductions are not collected in accordance with the terms of the loan agreement.

Inadequate supervision of familiar borrowers.

Over-reliance on verbal information furnished by borrowers in lieu of reliable financial

Downplaying of known credit weaknesses because of the borrower's past history of overcoming recurrent hazards and distress.

Ignoring warning signs pertaining to the borrower, economy, region, industry, or other related factors.

Lack of Supervision-Many loans that are sound at inception have developed into problems and losses because of lack of effective on-going supervision.

Technical Incompetence-Able and experienced bankers should possess the technical ability to analyze financial statements and to obtain and evaluate other credit information. Technical incompetence often results in unexpected losses.

Overlending-Loans granted beyond the borrower's reasonable capacity to repay are inherently unsound. Technical competence and sound credit judgment are necessary in determining a sound borrower's safe, maximum loan level.

Competition—Competition among branches for size and market share may result in the compromise of credit principles and the funding of unsound loans.

Nonaccrual and Restructured Loans

Working in a prudent manner with borrowers that are experiencing financial difficulties, branch management may restructure loans or take other measures in recognition of borrowers' condition and repayment prospects. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve a branch's prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements provide a framework for working in a constructive fashion with borrowers experiencing financial difficulties.

The Interagency Policy Statement on Credit Availability, issued on March 1, 1991, presented clarifications of a number of supervisory policies regarding issues relating to nonaccrual assets and restructured loans. These clarifications indicated that when certain criteria are met: (a) interest payments on nonaccrual assets can be recognized as income on a cash basis, without first recovering any previous partial charge-offs; (b) nonaccrual assets can be restored to accrual status when subject to formal restructuring in accordance with Financial Accounting Standards Board (FASB) Statement No. 15; and (c) restructuring that yields a market rate of interest would not have to be included in restructured loan amounts reported in the years subsequent to the year of the restructuring.

Nonaccrual of Interest

Loans and lease financing receivables are to be placed in nonaccrual status if:

- They are maintained on a cash basis because of deterioration in the financial condition of the borrower.
- Payment in full of principal or interest is not expected; or
- · Principal or interest has been in default for a period of 90 days or more, unless the loan is both well secured and in the process of collection.

A debt is well secured if it is secured (a) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt, including accrued interest, in full, or (b) by the guarantee of a financially responsible party. A debt is in the process of collection if collection of the asset is proceeding in due course either through legal action, including judgment enforcement procedures or, in appropriate circumstances, through collection efforts not involving legal action, which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

Treatment of Cash Payments and Criteria for the Cash Basis Recognition of Income-When doubt exists as to the collectibility of the remaining book balance of a loan in nonaccrual status, any payments received must be applied to reduce principal to the extent necessary to eliminate such doubt. Placing an asset in nonaccrual status does not, in and of itself, require a charge-off, in whole or in part, of the asset's principal. However, identified losses must be charged-off. When a loan is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis if the remaining book balance of the asset, after a charge-off, if any, is deemed to be fully collectible. A branch's determination as to the ultimate collectibility of the asset's remaining book balance must be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's historical repayment performance and other relevant factors.

When recognition of interest income on a cash basis is appropriate, the amount of income that is recognized should be limited to that which would have been accrued on the loan's remaining book balance at the contractual rate. For a formally restructured loan, the effective interest rate should be used. Any cash interest payments received in excess of this limit, and not applied to reduce the loan's remaining book balance, should be recorded as recoveries of previous charge-offs, until these charge-offs have been fully recovered.

Restoration to Accrual Status—According to the Revised Interagency Guidance on Returning Certain Nonaccrual Loans to Accrual Status issued June 10, 1993, nonaccrual loans may be returned to accrual status, even though the loans have not been brought fully current, provided two criteria are met: (1) all principal and interest amounts contractually due, including arrearages, are reasonably certain of repayment within a reasonable period and (2) there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in

accordance with the contractual terms, involving payments of cash or cash equivalents. However, loans that meet these criteria would continue to be disclosed as past due and still accruing for purposes of the Report of Assets and Liabilities (call report), until they have been brought fully current.

For purposes of meeting the first test, the branch must have received repayment of the past due principal and interest unless, as discussed below, the loan has been formally restructured and qualifies for accrual status or the asset has been acquired at a discount (because there is uncertainty as to the amounts or timing of future cash flows) from an unaffiliated third party and meets the criteria for amortization, i.e., accretion of discount, specified in AICPA Practice Bulletin No. 6.

Until the loan is restored to accrual status, cash payments received must be treated in accordance with the criteria stated above. In addition, after a formal restructuring, if a restructured loan that has been returned to accrual status later meets the criteria for placement in nonaccrual status as a result of past due status based on its modified terms or for any other reasons, the asset must be placed in nonaccrual status. Under GAAP, when a charge-off was taken before the date of the restructuring, the charge-off does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed in the previous paragraphs in this section are applicable.

Treatment of Multiple Extensions of Credit to One Borrower—As a general principle, nonaccrual status for an asset should be determined based on an assessment of the individual asset's collectibility and payment ability and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a branch does not have to place all other extensions of credit to that borrower in nonaccrual status. When a branch has multiple loans or other extensions of credit outstanding to a single borrower, and one loan meets the criteria for nonaccrual status, the branch should evaluate its other extensions of credit to that borrower to determine whether one or more of these other assets should also be placed in nonaccrual status.

Examiner Review—Some states have promulgated regulations or adopted policies for nonac-

crual of interest on delinquent loans, which may differ from the above procedures. In such cases, the branch should comply with the more restrictive policy. The examiner should ensure that the branch is complying with such guidelines. In all instances, whether or not there is a formal policy, each branch should formulate its own policies to ensure that income is not being overstated. The examiner should review the branch's specific policy to ensure that it is prudent.

When a branch places a loan in nonaccrual status, it must determine an appropriate treatment for previously accrued but uncollected interest and subsequent payments. One acceptable method is to reverse all previously accrued but uncollected interest against appropriate income and balance sheet accounts. For interest accrued in the current accounting period, the entry is made directly against the interest income account. For prior accounting periods, all interest previously recognized, if accrued interest provisions had not been provided, would be reversed (expensed) against current earnings.

Generally accepted accounting principles do not require the write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. A branch is expected to have a well-defined policy governing the write-off of accrued interest receivable.

Treatment of Nonaccrual Loans with Partial Charge-offs

Questions have been raised regarding whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must first be fully recovered before a loan can be restored to accrual status. GAAP and regulatory reporting requirements do not explicitly address this issue.

When a loan has been brought fully current with respect to contractual principal and interest and the borrower's financial condition and prospects for repayment have improved so that the full amount of contractual principal, including any amounts charged-off, and interest is expected to be repaid, the loan may be restored to accrual status without having to first recover the charge-off. On the other hand, this treatment would not be appropriate when the charge-off is indicative of continuing doubt regarding the collectibility of principal or interest. Because the criteria for

nonaccrual status include the requirement that loans or other assets be placed in nonaccrual status when repayment in full of principal or interest is not expected, such nonaccrual loans should not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be documented. Such actions should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal, including any amounts charged-off, and interest. This documentation will be subject to review by examiners.

Renegotiated Troubled Debt

Renegotiated troubled debt includes those loans and lease financing receivables that have been restructured or renegotiated to provide concessions to the borrower, e.g., a reduction of interest or principal payments because of a deterioration in the financial position of the borrower. A loan extended or renewed at a stated rate equal to the current interest rate for new debt with similar risk is not considered renegotiated debt. For further information, see Financial Accounting Standards Board Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructuring, (FASB Statement No. 15).

Branches should develop a policy relative to renegotiated troubled debt to ensure that such items are identified, monitored, and properly handled from an accounting and control standpoint. Such items should be relatively infrequent in occurrence. If not, the branch is probably experiencing significant problems. Before such concessions are made to a borrower, it is good practice to have the transactions receive prior approval of the head office. All such transactions should be reported to the head office upon enactment.

Nonaccrual Assets Subject to FASB Statement No. 15 Restructuring

The Policy Statement on Credit Availability Issues indicated that a loan or other debt instrument that has been formally restructured, so as to be reasonably certain of repayment and performance according to its modified terms in accordance with a reasonable repayment schedule, need not be maintained in nonaccrual status. Furthermore, the policy statement indicated that, in returning the asset to accrual status, sustained historical payment performance for a reasonable time before the restructuring may be taken into account.

For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. In so doing, the borrower's restructured terms may require payments that do not exceed the amount and frequency that have been demonstrated by the sustained historical payment performance of the borrower for a reasonable time before the loan was restructured. In this situation, assuming that the restructured loan is reasonably certain of repayment and performance according to its modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether before or after the date of the restructuring, is an important factor in determining whether there is reasonable assurance of repayment and performance according to the loan's modified terms. In certain circumstances, evidence may exist regarding other characteristics of the borrower that may be sufficient to demonstrate a relative improvement in the borrower's condition and debt service capacity, thereby reducing the degree of reliance on the borrower's performance to date in assessing prospects for future performance and collectibility under the modified terms. For example, substantial and reliable sales, lease, or rental contracts obtained by the borrower, or other important developments that are expected to significantly increase the borrower's cash flow and debt service capacity and strengthen the borrower's commitment to repay, may be sufficient to provide this assurance. In certain circumstances, a preponderance of such evidence, in and of itself, may be sufficient to warrant returning a restructured loan to accrual status, provided the loan under its restructured terms is reasonably certain of performance and full collectibility.

It is imperative that the reasons for the restoration of restructured debt to accrual status be fully documented. Such actions should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This documentation will be subject to review by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule. When a restructured loan is not reasonably certain of repayment and performance under its modified terms in accordance with a reasonable repayment schedule, the loan may not be restored to accrual status.

When restructuring loans, regulatory reporting requirements and GAAP do not require banking organizations to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay in order to use the reporting treatment specified in FASB Statement No.15. Furthermore, regulatory reporting requirements and GAAP do not preclude institutions from including prudent contingent payment provisions in the restructured terms that permit an institution to obtain appropriate recovery of concessions involved in the restructuring, should the borrower's condition substantially improve.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with FASB Statement No. 15 so that it meets the criteria for restoration to accrual status presented in the previous section that addresses restructured loans. Under GAAP, when a charge-off was taken before the date of the restructuring, the charge-off does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed in the previous paragraphs in this section are applicable.

Reporting of Loan Fees and Interest

The accounting standards for nonrefundable fees and costs associated with lending, commitments to lend, and purchasing a loan or group of loans, are set forth in FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases. The statement applies to all types of loans and to debt securities but not to loans or securities carried at market value and to all types of lenders. It must be applied to all lending and leasing transactions in fiscal years beginning after December 15, 1987, but retroactive application is permitted.

For further information, see FASB Statement No. 91.

All other lending-related costs, whether or not incremental, should be charged to expense as incurred, including costs related to activities performed by the lender or by independent third parties for the lender, for advertising, identifying potential borrowers, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Employees' compensation and fringe benefits related to these activities, unsuccessful loan origination efforts, and idle time should be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and should be charged to expense as

Net unamortized loan fees represent an adjustment of the loan yield and shall be reported in the same manner as unearned income on loans, i.e., deducted from the related loan balances, to the extent possible, or deducted from total loans in any unearned income on loans in the call report, which provides a breakdown of various types of loans. Net unamortized direct loan origination costs shall be added to the related loan balances. Amounts of loan origination, commitment, and other fees and costs recognized as an adjustment of yield should be reported under the appropriate Interest income item in the income statement. Other fees, such as fees that are recognized during the commitment period or included in income when the commitment expires, i.e., fees, retrospectively determined, and fees for commitments, where exercise is remote, and (b) syndication fees that are not deferred, should be reported as other noninterest income.

Other Lending Concerns

The transfer of low quality loans from one depository institution to another may be made to avoid detection and classification during regulatory examinations. Transfer may be accomplished through participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Examiners should be alert to situations where a branch's intention seems to be the concealment of low quality

assets for the purpose of avoiding examination scrutiny and possible classification.

During branch examinations, examiners should identify situations where low quality assets have been transferred between the branch being examined and another U.S. branch of a foreign bank or other depository institution. Low quality loans, broadly defined, include loans that are classified or specially mentioned or if subjected to review would most likely be classified or specially mentioned, past due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other loans that the examiner believes are of questionable quality.

Examining the Lending Function

The results of the loan examination should provide the examiner with a method of arriving at an overall evaluation for the entire branch loan portfolio. Historically, examination results have identified problems in the loan area through a detailed review of credits and credit documentation. The examiner should also correlate the following items with the overall system of policies, practices, procedures, and controls instituted by the branch to prevent such problems:

- Identified problem credits.
- Unsafe or unsound lending procedures.
- Past due loans.
- · Credit documentary exceptions.
- · Violations of laws and regulations.
- · Concentrations of credit.
- · Evidence of self-dealing loan transactions.
- Collateral documentary exceptions.

The purpose of this correlation is to determine causes of existing problems and weak situations, which represent a potential weakness in the branch's risk management process.

The examiner performing the procedures in this section should make the final decision as to the quality of the entire portfolio, the quality of management review and controls, and the scope and adequacy of internal guidelines. A great deal of judgment is necessary in making those decisions because they significantly affect the overall conclusions reached by the examiner-incharge. The process of compiling information generated, analyzing it, and formulating conclusions about the causes of existing deficiencies,

requires considerable thought and judgement on the part of the examiner. The ultimate conclusions concern the risk management of the lending function, as it now exists, and as it is projected for the future. Furthermore, the examiner is expected to discern causes of existing and potential problems, to capsulize the causes and effects, and to present the problems to branch management in such a manner as to obtain positive corrective action.

Regulatory Compliance

Branches are expected to comply with laws, regulations, and applicable regulatory policy in all aspects of their lending programs. Moreover, branches should establish adequate internal controls to detect deficiencies or exceptions to their lending policy that result in unsafe and unsound lending practices. In regard to applicable lending limits, the examiner should review the branch's lending practices in accordance with the applicable state laws in the following areas that prescribe limits on aggregate advances to a single borrower and related borrowers.

Commissions or Gifts for Procuring Loans. A branch officer, employee, agent, or attorney should not receive anything of value for procuring or endeavoring to procure a loan, which is prohibited under 18 USC 215.

Political Contributions. Loans made in connection with any election to any political office should comply with applicable state banking laws and regulations and with the Foreign Corrupt Practices Act of 1977 (Pub. L. 95-213, 91 Stat. 1494 (1977), 15 USC 78dd-1 and 2, 78m, 78o, and 78ff) and the Federal Election Campaign Act (2 USC 441b).

Loans to Executives, Officers, and Principal Shareholders of Correspondent Banks. No preferential treatment should be given to loans to insiders of correspondent banks nor should there be the appearance of a conflict of interest. The branch should comply with Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)).

Appraisals and Evaluations. Federally-insured branches should obtain an appraisal or evaluation for all real estate-related financial transactions prior to making the final credit decision in conformance with Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) (12 USC 3310, 3331-3351). Appraisal and evaluation requirements are separately discussed in the Real Estate Appraisals and Evaluations part of this section.

Consumer Compliance. The residential lending program at a federally-insured branch should ensure that the loan applicant is adequately informed of the annual interest rate, finance charges, amount financed, total payments, and repayment schedule, as mandated in the Federal Reserve's Regulation Z, Truth in Lending (12 CFR 226). The federally insured branch's process for taking, evaluating, and accepting or rejecting a credit application is subject to the Federal Reserve's Regulation B, Equal Credit Opportunity (12 CFR 202).

Credit Life Insurance Income. The branch's sale of mortgage life insurance in connection with its real estate lending activity should comply with the sales practices, sales commission limits, and disclosure requirements as defined in the Federal Reserve's policy statement on the disposition of credit life insurance income (67 Federal Reserve Bulletin 431 (1981), FRRS 3–1556).

Credit Risk Management Examination Objectives

Effective date July 1997

Section 3010.2

- To determine if policies, practices, procedures, and internal controls regarding credit risk management are adequate.
- 2. To determine if branch officers are operating in conformance with the established guidelines.
- 3. To determine the scope and adequacy of the audit and loan review functions.
- 4. To determine the overall quality of the loan portfolio and how that quality relates to the risk management function of the branch.
- 5. To prepare information regarding the branch's lending function in concise reportable format.
- 6. To determine compliance with applicable laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of applicable law or regulations have been noted.

Credit Risk Management Examination Procedures

Effective date July 1997

Section 3010.3

The following procedures are intended to determine that the branch under examination has established satisfactory procedures to ensure that controls regarding credit risk management are adequate. Examiner discretion is required in applying these procedures. Before beginning the assignment, the examiner should review the scope memorandum and consult with the examiner-in-charge or other designated individual to determine the scope of the review. Some of the procedures may not be necessary, based on the quality of the branch's internal controls or the nature and level of activity in the area.

- If selected for implementation, complete, or update the Internal Control Questionnaire for this section.
- Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
- Reconcile the customer central liability ledger or subsidiary loan ledgers to the general ledger.
- Obtain the branch's internal listing of Shared National Credits and verify ratings with regulatory records.
- 5. Review the branch's lending policies to determine:
 - a. If the policies are adequate for the size, nature, and business of the bank.
 - b. If the branch is in compliance with its policies.
 - c. If the policies are reviewed and updated periodically to ensure they are relevant with changing market conditions and new business lines of the bank.
 - d. If policies have been approved by the head office.
- 6. If applicable, review minutes of the branch's loan committee meetings to determine:
 - a. Current members and their attendance record.
 - b. Scope of work performed.
 - Any information deemed useful in the examination of specific loan categories or other areas of the branch.

LOAN REVIEW

In general, a loan review program should provide an independent means to identify credit and loan administration weaknesses, provide accurate and timely reports to management detailing weaknesses discovered, and provide a means for recognizing potential problems.

- 7. Determine if the loan review program ensures independence from the lending function including whether:
 - Policies specifically address the separation of loan review from the lending and credit approval functions.
 - b. The loan review function reports directly to the head office, a regional office, or a senior branch officer not involved in the lending function. If not, determine if the branch has adequate controls to ensure independence from the lending function.
- 8. Determine if the frequency of loan review is adequate, and if the program includes:
 - a. A minimum frequency of reviews.
 - A frequency which is sufficient to provide timely information concerning emerging trends in the portfolio and general economic conditions.
 - c. Increased frequency for identified problem credits.
- 9. Evaluate the adequacy of the scope of the loan review, including:
 - a. Method of loan selection.
 - b. Manner in which loans are reviewed, including:
 - an analysis of the current financial condition of the borrower which addresses repayment ability, and
 - tests for documentation exceptions, policy exceptions, noncompliance with internal procedures, and violations of laws and regulations.
- 10. Assess the qualifications of the personnel involved in the credit review function.
- 11. Evaluate the loan review reporting system including credit file memoranda, head office reports, and an annual schedule or loan review plan, to ensure it is thorough, accurate and timely and will provide sufficient information to allow management and the head office to both identify and control risk.

Determine if the reports include:

- a. Identification of problem credits.
- b. Current information regarding portfolio risk.
- Information concerning emerging trends in the portfolio and the branch's lending areas.

CREDIT GRADING SYSTEM

- 12. Assess the adequacy of the credit grading system and determine if it:
 - Includes an objective grading system for loans.
 - Contains explicit definitions of the branch's internal grading system, and that it is easily understood by all lenders and loan review staff.
 - c. Designates who has ultimate authority to assign and change credit grades.
- 13. Evaluate the accuracy of the branch's credit grading system by comparing the credit grade assigned by the branch with those assigned by examiners. Determine the extent of management's knowledge of its own loan problems.

GENERAL CREDIT RISK ADMINISTRATION

- 14. Assess the effectiveness of the branch's credit administration and portfolio management by evaluating:
 - Management's general lending philosophy in such a manner as to elicit management responses.
 - b. The volume and magnitude of differences in grades assigned by the branch and by the examiners.
 - The impact of credits not supported by current and complete financial information and analysis of repayment ability.
 - d. The impact of credits for which loan and collateral documentation are deficient.
 - e. The volume of loans improperly structured, e.g., repayment schedule does not match loan purpose.
 - f. The volume and nature of concentrations of credit, including concentrations of classified and criticized credits.
 - g. The appropriateness of transfers of low quality credits to or from another affiliated office.

- h. The accuracy and completeness of reports submitted to the head office or regional office.
- Competency of senior management, loan officers and credit administration personnel.
- 15. Determine, through information previously generated, the causes of existing problems or weaknesses within the system, which present potential for future problems.

PROBLEM LOAN ADMINISTRATION

- 16. Determine if the branch has adequate policies and procedures for problem and work-out loans, including:
 - a. A periodic review of individual problem credits.
 - Guidelines for collecting or strengthening the loan, including requirements for updating collateral values and lien positions, documentation review, officer call reports.
 - Volume and trend of past due or nonaccrual credits.
 - d. Qualified officers handling problem loans.
 - e. Guidelines on proper accounting for problem loans, e.g., non-accrual policy; specific reserve policy.

COMPLIANCE

- 17. Assess the branch's compliance with laws and regulations, by determining whether:
 - a. The branch has loans to affiliates (Section 23A of the Federal Reserve Act).
 - b. A bank officer or employee received anything of value for procuring or endeavoring to procure any extension of credit (18 USC 215 for Commission or Gift for Procuring a Loan).
 - c. The branch has a stated purpose for each loan over \$10 thousand, except those secured by real estate (31 CFR 103.33(a) of the Bank Secrecy Act).
 - d. The branch is in compliance with state and federal lending limits, as described in Regulation K, or specific statutes.
 - The branch is in compliance with Regulation O regarding loans to insiders. (applicable to FDIC-insured branches only).

Forward any violations of law to the examiner in charge of compliance, and include a cross reference here.

SPECIFIC RESERVES

- 19. Ensure that any specific reserves reported by the branch are appropriate, i.e., based on a specific loss amount that has been identified for an individual credit.
- Determine if the branch accounts for specific reserves appropriately when the underlying asset has been transferred, sold, or paid off.
- 21. Review the management reports submitted to the head office, to determine that reports are sufficiently detailed to evaluate risk factors
- 22. Summarize your findings being sure to consider the following:
 - a. Check for noncompliance with internal policies, practices, procedures, and controls. Determine if instances of noncompliance are system-wide or limited to a specific area.
 - b. Organize exceptions in order of relative importance.
 - c. Organize and prepare a listing of violations of laws and regulations.
 - d. Determine the aggregate amount of loans criticized in each of the four levels of criticism

- e. Compile a listing of all loans not supported by current and complete credit information and collateral documentation.
- f. Compile a listing of low quality loans transferred to or from another lending institution through purchases/sales, participations, or swaps.
- 23. Discuss results of the examination of the lending function with senior management, structuring inquiries in such a manner as to:
 - a. Elicit management responses for correction of deficiencies.
- 24. Write, in appropriate report format, general remarks including:
 - a. The scope of the examination of the lending function.
 - The quality of internal policies, practices, procedures, and controls over the lending function.
 - The general level of adherence to internal policies, practices, procedures, and controls.
 - d. The scope and adequacy of the internal loan review system.
 - e. The quality of the entire loan portfolio.
 - f. The competency of management with respect to the lending function.
 - g. Causes of existing problems.
 - h. Expectations for continued sound lending or correction of existing deficiencies.
- 25. Prepare a complete set of workpapers to support conclusions, and discuss all material findings with management.

Credit Risk Management Internal Control Questionnaire

Effective date July 1997

Section 3010.4

Review the branch's internal controls, policies, practices, and procedures for managing the loan portfolio. The system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

- 1. Has a policy for credit risk management been adopted that specifically:
 - a. Establishes suggested guidelines for distribution of loans in the commercial, real estate, and other categories?
 - b. Establishes geographic limits, including country limits, for loans?
 - c. Establishes suggested guidelines for aggregate outstanding loans in relation to other balance sheet categories?
 - d. Establishes loan authorities of committees and individual lending officers?
 - e. Defines acceptable types of loans?
 - f. Establishes maximum maturities for various types of loans?
 - g. Establishes loan pricing?
 - h. Establishes appraisal policy?
 - i. Establishes minimum financial information required at the inception of the credit?
 - j. Establishes limits and guidelines for purchasing loans?
 - k. Establishes collection procedures?
 - 1. Defines the duties and responsibilities of loan officers and loan committees?
 - m. Outlines loan portfolio management objectives that acknowledge the need to employ personnel with specialized knowledge and experience?
- 2. Are the following reported to the head office at least monthly:
 - a. Past due loans?
 - b. Loans on nonaccrual?
 - c. Classified loans?
 - d. Loans requiring special attention?
 - e. New loans, loan renewals, and restructured loans?
- 3. Are reports checked by a designated individual for possible omissions before they are submitted to the head office?
- 4. Are written applications required for all loans?

Do credit files contain the following information:

GENERAL INFORMATION

- The borrower's name, address, ownership, and affiliations?
- A description of the borrower's business?
- Amount, rate and maturity of the loan; type of loan; appropriate approvals?
- The purpose of the loan?
- The primary and secondary sources of repayment?
- The planned repayment schedule?
- The disposition of the loan proceeds?

FINANCIAL INFORMATION

- Current financial information on the borrower and guarantor (if applicable)?
- Three years of previous financial statements?
- An analysis of the borrower's and guarantor's (if applicable) financial condition?
- Projections for the borrower's future financial performance?
- A description of the collateral, its location, value, and condition?
- Covenant compliance checksheet, if applicable.
- 6. Does the branch perform a credit investigation on proposed and existing borrowers for new loan applications?
- 7. Is it required that all loan commitments be in writing?
- 8. Are lines of credit reviewed and updated at least annually?
- 9. Are borrowers' outstanding liabilities checked to appropriate lines of credit before additional advances are granted?
- 10. Does the branch employ a procedure for disclosure of a loan or combination of loans that are or will be secured by 25 percent of another insured financial institution's stock?
- 11. Is there an internal review system that:
 - a. Rechecks interest, discount, and maturity date computations?
 - b. Reexamines notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?

- Determines that loan approvals are within the limits of the branch's lending authorities?
- d. Determines that notes bear the initial of the loan officer?
- e. Ascertains that new loans are within the limitations set for the borrower by corporate resolution?
- f. Rechecks the liability ledger to determine that new loans have been accurately posted?

Loan transfers, purchases and sales involving other U.S. branches and affiliates of the FBO are evaluated to determine whether branch management retains responsibility for the loan. In such a case, the management of the transferred loans will be considered in assessing risk management at the branch. Loan transfers are also evaluated to determine whether they were transferred to avoid classification and to determine any effect of the transfer on the institution's condition. In cases where the transfer is suspected of being improper, the appropriate regulatory authorities for the other financial institution involved in the transfer should be notified

- 12. Review loan transfers for the following:
 - Determine that the branch does not buy back or pay interest on defaulted loans in contravention of the underlying loan agreement.
 - b. Compare the volume of loans purchased and sold to the total portfolio.
 - Determine that the branch has sufficient expertise to properly evaluate the volume of loans purchased and sold.
 - d. Determine if loans are sold primarily to accommodate overline needs of customers or to generate fee income.
 - e. Investigate any situations where assets were transferred before the date of the examination to determine if any were transferred to avoid possible criticism during the examination.
 - f. Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous exami-

- nation, or were considered to be of questionable quality for any other reason.
- g. Review the branch's policies and procedures to determine whether or not assets or participations purchased by the branch are given an independent, complete, and adequate credit evaluation.
- Determine that assets purchased by the branch are properly reflected on its books at fair market value.

While fair market value may be difficult to determine, it should, at a minimum, reflect both the rate of return being earned on such assets and an appropriate risk premium. Determine that appropriate write-offs are taken on any assets sold by the branch at less than book value.

- 13. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?
- 14. Has the branch conducted industry studies for those industries in which it is a substantial lender?
- Are loan proceeds ever disbursed in cash? If so, notify BSA examiner.
- 16. Are loans ever paid off by liquidating cash collateral? If so, notify BSA examiner.
- 17. Are adequate accounting and control procedures in effect with respect to recoveries?
- 18. Are adequate procedures in effect to monitor compliance with the lending limits?
- 19. Are original loan documents safeguarded properly?
- 20. Are notes and collateral periodically verified by an independent party?

CONCLUSION

- 21. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Credit Risk Management Audit Guidelines

Effective date July 1997

Section 3010.5

- Test the additions of the trial balances and the reconciliation of the trial balances to the general ledger. Include loan commitments and other contingent liabilities.
- Using an appropriate sampling technique, select loans from the trial balance and perform the following:
 - a. Prepare and mail confirmation forms to borrowers. Loans serviced by other institutions, either whole loans or participations, should be confirmed only with the servicing institution. Confirmation forms should include borrower's name, loan number, the original amount, interest rate, current loan balance, contingency and escrow account balance, and a brief description of the collateral.
 - b. After a reasonable time, mail second requests.
 - c. Follow up on any no-replies or exceptions, and resolve differences.
 - d. Examine notes for completeness and verify date, amount, and terms to trial balance.
 - e. In the event any notes are not held at the branch, request confirmation by the holder.
 - f. Check to see that the note is signed, appears to be genuine, and is negotiable.
 - g. Check to see that the required initials of the approving officer are on the note.
 - h. Determine that the amount is within the officer's lending limit.
 - i. Compare collateral held in files with the description on the collateral register.
 - Determine that the proper assignments, stock powers, hypothecation agreements, statements of purpose, etc., are on file.
 - k. Test the pricing of the negotiable collateral.
 - Determine that margins are reasonable and are in line with branch policy and legal requirements.
 - m. Determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.
 - n. Forward a confirmation request on any collateral held outside the branch.
 - For accounts receivable financing, reconcile accounts receivable invoices to collateral records.

- p. For banker's acceptances, compare collateral (e.g. trust receipts and warehouse receipts) with the description on the collateral records. Check to be sure that procedures are in effect to preclude a customer from obtaining additional credit extensions on the same merchandise.
- q. Review escrow account provisions to determine if undisbursed amounts are at least equal to the provisions in the escrow agreements. Determine if debit entries to escrow accounts are authorized according to the terms of the loan agreement and if they are supported by individual bills or other evidence.
- r. List all discrepancies and investigate.
- s. Determine that each file has documentation supporting guarantees and subordination agreements, where appropriate.
- Determine that any necessary insurance coverage is adequate and that the branch is named as loss payee.
- u. Review participation agreements, making excerpts where necessary for such items as rate of service fee, interest rate, retention of late charges, and remittance requirements, and determine whether participant has complied.
- Review disbursement ledgers and authorizations and determine if authorizations are signed in accordance with the terms of the loan agreement.
- 3. Review the accrued interest accounts by:
 - Reviewing and testing procedures for accounting for accrued interest and for handling of adjustments.
 - Scanning accrued interest for any unusual entries and following up on any unusual items by tracing to initial and supporting records.
 - c. For those loans selected in step 2, independently calculate the amount of accrued interest and verify the amount to the detail of accrued interest receivable for that loan.
- Using a list of nonaccruing loans, check loan accrual records to determine if interest income is not being recorded.

- 5. Obtain or prepare a schedule showing the monthly interest income amounts and the accounts receivable loan balance at each month-end since the last audit and:
 - a. Calculate yield.

- b. Investigate significant fluctuations and/or
- 6. Test accuracy and completeness of all management reports.

Effective date July 1997

Asset-based lending is a specialized area of commercial lending in which borrowers assign their interests in certain accounts receivable and inventory, and in selected cases, fixed assets, to the lender as collateral. In asset-based lending, the primary repayment source is the conversion of the pledged assets into cash. Asset-based lending differs from a commercial loan in which the bank takes a security interest in all accounts receivable and inventory owned or acquired by the borrower. This section will discuss assetbased lending in relation to the characteristics of the borrower, its advantages to the borrower and the branch, credit and collateral analysis, documentation, and safeguards to ensure the authenticity and collectibility of the assigned receivables.

The examiner must judge the quality of the credit by evaluating the financial condition and debt-servicing ability of the borrower and the quality of the collateral. In addition, the examiner must evaluate the branch's internal controls, policies, practices, and procedures.

CHARACTERISTICS OF THE BORROWER

Many borrowers whose financial condition is not strong enough to allow them to qualify for regular, secured commercial loans may use assetbased loans to meet their financial needs. Typical characteristics of asset-based borrowers are those which:

- Are growing rapidly and need year-round financing in amounts too large to justify unsecured credit or commercial lines of credit secured by blanket liens on accounts receivable and inventory;
- Are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic clean-ups;
- Have inadequate working capital for the volume of sales and type of operation; and,
- Cannot obtain regular commercial loan terms because of deteriorating credit factors.

ADVANTAGES TO THE BORROWER AND THE BRANCH

From the borrower's viewpoint, asset-based lending:

- Provides an efficient way to finance an expanding operation because borrowing capacity expands as sales increase;
- Permits the borrower to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors on a satisfactory basis, thereby earning a good reputation and reducing the cost of goods sold;
- Ensures a revolving, expanding line of credit for which the actual interest paid may be less than that for a fixed amount unsecured loan.

From the branch's viewpoint, asset-based lending:

- Generates a relatively high yield loan commensurate with the perceived credit risk of the borrower:
- Generates a depository relationship which provides income and enhances the branch's ability to monitor changes in the borrower's cash flow and overall financial condition;
- Permits a continuing branch relationship with longstanding customers whose financial condition no longer warrant unsecured credit or traditional commercial lines of credit; and,
- Minimizes potential loss when the loan is collateralized by a percentage of the accounts receivable and inventory.

However, as discussed further, this type of lending requires close and periodic supervision of the borrower's financial condition and regular monitoring of the borrower's accounts receivables to ensure compliance with the financing agreement.

CREDIT AND COLLATERAL ANALYSIS

Although asset-based loans are collateralized and closely monitored, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and supports the loan, the borrower must demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort. The borrower's financial statements should be analyzed with particular emphasis on working capi-

tal and its trends. Trade reports should be reviewed, the agings of receivables and payables should be scrutinized, and inventory turnover should be analyzed. Furthermore, the prompt payment of taxes, especially payroll taxes, should be verified. A primary reason for a company to obtain asset-based financing is to maximize discounts offered by suppliers; therefore, it should pay creditors promptly upon receiving the financing. If it is not doing so, it may be diverting the funds out of the business and/or the company's financial condition may not warrant this type of financing.

Branch management's ability to recognize a customer's financial problems as they develop and to initiate orderly liquidation, if necessary, is important in the supervision of asset-based financing. The line theoretically could be fully liquidated by discontinuing further advances, collecting the assigned receivables and liquidating pledged inventory. However, such drastic action could cause the borrower's business to close resulting in a probable deterioration of the receivables from new disputes and in returns and offsets. So that the branch's loan may be liquidated in an orderly manner without losses or other adverse effects, the branch usually notifies its borrower of a contemplated liquidation, allowing the borrower time to seek other means of continuing the business. Asset-based lines where the financial position has declined so that refinancing is prevented should be criticized, unless the branch has initiated an orderly liquidation. When such a liquidation is occurring, the examiner may not see the need for classification if the borrower's business is continuing, the existing collateral is of good quality, and no collateral deterioration is anticipated.

In asset-based lending, branch management should continually evaluate the realizable value of assets pledged. To do so, management should review the loan agreement and compliance therewith; the quality of the assets pledged, including documentation; and the safeguards to ensure the authenticity and collectibility of the pledged assets. The information obtained is sometimes difficult to interpret unless it is related to other periods, comparable businesses, or industry statistics. The following factors should be considered in evaluating the quality of assets pledged:

The turnover of the receivables pledged and the borrower's credit limit. If the turnover is decreasing, the quality of receivables may be deteriorating.

Aging of accounts receivable. The branch should obtain a monthly aging of the accounts receivable pledged. The examiner should note the percentage of accounts delinquent in relation to the total accounts pledged, and those accounts having past due balances, which also have current amounts due.

Concentration of debtor accounts. A lender may be vulnerable to loss if a large percentage of the dollar amount of receivables assigned is concentrated in a few accounts. A list of concentrations should be prepared periodically showing the largest accounts.

Ineligible receivables. The examiner should be aware of receivables that, by their nature, should be excluded from the lending formula. The following are examples of receivables that may be considered ineligible:

- Due from affiliated companies. Although such receivables might be valid, the temptation for the borrower to create fraudulent invoices would be great.
- Receivables subject to a purchase money interest, such as floor plan arrangements. The manufacturer will frequently file financing statements when merchandise is delivered to the borrower. That filing usually gives the manufacturer a superior lien on the receivable. An alternative would be to enter into an agreement with the manufacturer where rights to the receivables are subordinated to the branch

Financial strength of debtor accounts. The branch should maintain credit information and trade reports on large debtor accounts as part of the borrower's credit file. The examiner should determine whether the debtor accounts are significant to the borrower's business and are well rated and financially strong.

Disputes, returns, and offsets. The borrower should furnish promptly to the branch copies of all significant credit memoranda issued. An analysis of those memoranda must be made. A large or increasing volume of such transactions could adversely affect the branch's collateral position.

DOCUMENTATION

Loan Agreement—An asset-based loan agreement is a contract between a borrower and the branch that sets forth conditions governing the handling of the account and the remedies available in the event of default. Among the major provisions, might be:

- A percentage advance against acceptable receivables. The advance may depend on the gross profit margin from the sale of merchandise and the credit quality of the borrower's customers. For example, if a borrower has a gross profit margin of 30 percent, the maximum advance might be 70 percent, with a reduced percentage if the borrower's customers do not have top credit ratings.
- Use of only acceptable receivables. This term refers to a branch's outlining qualifications for acceptance. For example, acceptable receivables may include only those accounts that are current or not more than a given number of days past due. The entire amount of receivables may be unacceptable if a certain percentage, e.g., 10 percent, is 90 days or more delinquent.
- A maximum dollar amount due from any one account debtor. Because there is always the possibility of unforeseen and undisclosed credit failure or a return of merchandise, a common benchmark is that no more than 20 percent of the receivables assigned are from one customer.

Documentation of Advances—There are two dominant methods by which advances are made. Under the blanket assignment method, the borrower periodically supplies the branch with documentation of the amount of receivables outstanding on its books. Based upon this information, the branch advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a non-notification basis and payments on receivables are made directly to the borrower, who then remits them to the branch. The branch applies all or a portion of such funds to the borrower's loan and/or the cash collateral account, which is under the branch's control. Under the ledgering of accounts method, the lender receives duplicate copies of the invoices together with the shipping documents and/or delivery receipts. Upon receipt of satisfactory information, the branch advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a notification basis. Under this method, the branch maintains complete control of all funds paid on all accounts pledged by requiring the borrower's customer(s) to remit directly to the branch. The same application of payments is then used as under the blanket assignment method. Regardless of the methods used, the branch should ensure its collateral through a program of regular audit and direct confirmation.

Security Agreement and Financing Statement—Article 9 of the Uniform Commercial Code (UCC) applies to any transaction that is intended to create a security interest in accounts receivable. Under the UCC, the branch must create a valid and enforceable security interest and perfect that interest. Once an enforceable security interest is created, the secured party can always enforce it, on default, against the debtor, provided there is no superior third-party interest. If the holder of a valid and enforceable Article 9 interest takes the additional steps required to perfect under Article 9, it will defeat most such third parties.

Under the provisions of the UCC, a branch should request from the Secretary of State, or other filing office, a listing of any open liens on the customer's receivables or inventory. Providing no such liens are outstanding, the branch should then obtain a Security Agreement, Accounts Receivable and a Financing Statement and file promptly. The security agreement and financing statement should cover current and future accounts and advances for all proceeds thereof (a "blanket assignment"), or detail the specific item(s) being taken as collateral (a "specific assignment"). To protect its rights to the receivables, the lending branch should consider taking a lien on the borrower's current and future inventory and all proceeds thereof.

Sections 9-203 and 9-204 of the UCC require that the parties take four steps to create a valid and enforceable security interest. They must:

- Enter into a security agreement.
- Reduce as much of that agreement to writing as is necessary to satisfy Section 9-203, which also requires that the debtor sign this writing or give possession of the collateral to the creditor.
- Have the debtor acquire rights in the collateral.
- · Have the secured party give value.

Section 9-302(10) provides for automatic perfection, without filing a financing statement, when any or all assignments to the branch do not transfer a significant part of the outstanding accounts of the borrower. However, in all other accounts receivable security interests, the branch must file a financing statement to perfect its security interest. The law of the jurisdiction in which the debtor is located provides where the financing statement must be filed. Filing location is determined by place of business, executive office, or residence if the debtor has no place of business in the state. Refer to the appropriate State jurisdiction for filing instructions.

The financing statement, which is the document filed for public notice, must:

- Give the names and mailing addresses of the debtor and secured party.
- Be signed by the debtor.
- Give an address of the secured party from which information concerning the security interest may be obtained.
- Give the mailing addresses of the debtor and the secured party.
- Contain a statement indicating the types of collateral or describing the items or collateral.
- · Be renewed every five years.

A copy of the security agreement is sufficient as a financing statement if it meets the preceding requirements.

Although effective compliance with the UCC creates, in most instances, a valid and enforceable first lien, it does not insulate the branch from the need to police its collateral. By filing, the branch establishes the right to collect on only those receivables assigned to it, provided:

- The sales are legitimate.
- The merchandise has been delivered.
- · The merchandise is as ordered.
- Sales were made without warranties (almost all sales are covered by warranties).
- The merchandise was not shipped on consignment.
- The merchandise is not subject to offset, i.e., contra accounts or liens.
- The receivable has not already been paid to the borrower.

ENSURING AUTHENTICITY AND COLLECTIBILITY

Regardless of the advance methods used, the following safeguards, which branch management should consider and the examiner should evaluate, ensure the authenticity and collectibility of the pledged assets:

Audits. To verify the information supplied by the borrower to the branch, the branch sends its staff member(s) to the borrower's place of business to audit its books. The audit should occur several times a year, usually on a quarterly basis. The scope of such audit should include preparation of balance sheets, profit and loss statements, working capital analysis, agings of payables and receivables, an inspection of inventory and related records, and a determination that the debtor accounts are properly marked on the books as assigned to the branch. The audit also should include procedures to determine whether all significant credit memoranda have been properly issued and reported by the borrower to the branch.

Confirmations. To verify the authenticity of the pledged collateral, the branch should institute a program of direct confirmation. This procedure is particularly important if the accounts receivable are pledged on a non-notification basis because the branch does not have the same control of the debtor accounts as it does when the receivables are pledged on a notification basis. Direct confirmations should be made before the initial lending arrangement and, thereafter, at least semiannually. Confirmations should be on a positive basis. The branch should obtain written approval from the borrower before confirming accounts receivable on a non-notification basis. Further, the branch should consider using the name of a phantom company as sender of the confirmations and having the confirmations returned to a post office box to ensure that account debtors do not know that their receivables are being pledged.

Asset-Based Lending Examination Objectives

Effective date July 1997

Section 3020.2

- To determine if the policies, practices, procedures, and internal controls regarding assetbased lending are adequate.
- 2. To determine if branch officers are operating in conformance with the established guidelines.
- 3. To evaluate the portfolio for collateral sufficiency, credit quality, and collectibility.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Asset-Based Lending Examination Procedures

Effective date July 1997

Section 3020.3

Refer to the Credit Risk Management examination procedures for general procedures to assess the risk of asset-based lending activities. However, if the branch engages in significant assetbased lending activities, and additional information is needed, the examiner should perform the following examination procedures.

- If selected for implementation, complete or update the Internal Control Questionnaire for this area.
- Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
- 3. Review the following information for selected asset-based loans:
 - Relationship between amount collected in a month on the receivables pledged as collateral and the borrower's credit limit.
 - b. Aging of accounts receivable.
 - c. Ineligible receivables.
 - d. Concentration of debtor accounts.
 - e. Financial strength of debtor accounts.
 - f. Disputes, returns, and offsets.
 - g. Management's safeguards to ensure the authenticity and collectibility of the assigned receivables.

- Analyze secondary support offered by guarantors and endorsers.
- Ascertain compliance with established branch policy.
- 6. Discuss with appropriate officer(s) and prepare a summary of the branch's asset-based lending activities.
- 7. Evaluate the function with respect to:
 - a. The adequacy of written policies relating to asset-based lending.
 - b. The manner in which branch officers are conforming with established policy.
 - c. Adverse trends within the asset-based lending department.
 - d. Accuracy and completeness of the management reports relating to asset-based lending obtained from the branch.
 - e. Internal control deficiencies or exceptions.
 - f. Recommended corrective action when policies, practices, or procedures are deficient.
 - g. The competency of departmental management.
 - h. Other matters of significance.
- 8. Update the workpapers with any information that will facilitate future examinations.

Asset-Based Lending Internal Control Questionnaire

Effective date July 1997

Section 3020.4

Refer to the Credit Risk Management internal control questionnaire for a general review of the branch's internal controls, policies, practices, and procedures. If the branch engages in significant asset-based lending activities, and additional information is needed, the examiner should complete the following internal control questionnaire. For audit procedures, refer to the Credit Risk Management section 3010.5.

- Does the branch have policies specifically relating to asset-based lending that:
 - a. Establish procedures for reviewing assetbased lending applications?
 - b. Establish standards for determining credit lines?
 - c. Establish standards for determining the percentage advance to be made against acceptable receivables?
 - d. Define acceptable receivables?
 - e. Establish minimum requirements for verification of borrower's pledged assets?
 - f. Establish minimum standards for documentation?
- 2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

- 3. Does the branch record on a timely basis a first lien on the assigned receivables for each borrower?
- 4. Do all loans granted on the security of the receivables also have an assignment of the inventory?
- 5. Does the branch verify the borrower's accounts receivable or require independent verification on a periodic basis?
- 6. Does the branch require the borrower to provide aged accounts receivable schedules on a periodic basis?

CONCLUSION

- Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 8. Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Effective date July 1997

Banking organizations, including branches, have long been involved with asset-backed securities (ABS), both as investors in such securities and as major participants in the securitization process. In recent years, they have stepped up their involvement by increasing their participation in the long-established market for securities backed by residential mortgage loans. Banking organizations have also expanded their securitization activities to include other types of assets, such as credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables.

AN OVERVIEW OF ASSET SECURITIZATION

In recent years, the number of banking organizations that have issued securities backed by their own assets and that have acquired ABS as investments has increased markedly. This increase has resulted because securitization activities can yield significant financial and operational benefits.

In its simplest form, asset securitization involves the selling of assets. The process first segregates generally illiquid assets into pools and transforms them into capital market instruments. The payment of principal and interest on these instruments depends on the cash flows from the assets in the pool underlying the new securities. The new securities may have denominations, cash flows, and other features that differ from the pooled assets making the securities in them more attractive to investors.

The federal government encourages the securitization of residential mortgages. In 1970, the Government National Mortgage Association (GNMA) created the first publicly traded mortgage-backed security. Soon, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), both government-sponsored agencies, also developed mortgage-backed securities. The guarantees provided by these government or government-sponsored entities assure investors of the payment of principal and interest and have thus greatly facilitated the securitization of mortgage assets. As previously mentioned, securities have also been issued that are backed by other assets such as: credit card receivables, automobile loans, boat loans, commercial real estate loans, home equity loans, student loans, nonperforming loans, and lease receivables.

BENEFITS AND RISKS OF ASSET SECURITIZATION

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

It may be appropriate for a banking organization, including a branch, to engage in securitization activities and to invest in ABS, if it does so in a prudent manner. Nonetheless, these activities can significantly affect a branch's overall risk exposure. It is of great importance, particularly given the growth and expansion of such activities, that examiners be fully informed of the fundamentals of the securitization process, including knowledge of the various risks that securitization and investing in ABS create for branches. Additionally, examiners need to be aware of the pertinent examination procedures in order to effectively assess the branch's exposure to risk and its ability to manage that exposure.

3030.1 Asset Securitization

The following instructions were developed for Federal Reserve System use in order to provide examiners with the information and guidance they need on asset securitization. These instructions discuss the mechanics of securitization and related accounting issues while also providing a set of examination guidelines, objectives, and procedures. The various state and federal agencies may differ in terms of specific practices and methodologies used to implement these guidelines. For further guidance in this area, examiners should consult with their respective agencies.

THE SECURITIZATION PROCESS

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

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

A guarantor may also be involved to ensure that principal and interest payments will be received by investors on a timely basis, even if the servicer does not collect these payments from the obligors. Many issues of mortgage-backed securities are guaranteed directly by GNMA, a government agency backed by the full faith and credit of the U.S. government, or by FNMA or FHLMC, both government-

sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued, mortgage-backed securities and other types of asset-backed securities generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from a portion of or all credit losses. Usually, the amount of the credit enhancement is based upon several multiples of the historical losses experienced on the particular asset backing the security.

Credit Enhancement

One form of credit enhancement is the recourse provision, or guarantee, that requires the originator to cover any losses up to an amount contractually agreed upon. Some asset-backed securities, such as those backed by credit card receivables, typically use a spread account. This account is actually an escrow account. The funds in this account are derived from a portion of the spread between the interest earned on the assets in the underlying pool and the lower interest paid on securities issued by the trust. The amounts that accumulate in the account are used to cover credit losses in the underlying asset pool up to several multiples of historical losses on the particular asset collateralizing the securities.

Overcollateralization, another form of credit enhancement covering a predetermined amount of potential credit losses, occurs when the value of the underlying assets exceeds the face value of the securities. A third form of credit enhancement involves the use of the senior-subordinated security structure. Under such a structure, at least two classes of asset-backed securities are issued, with the senior class having a priority claim on the cash flows from the underlying pool of assets. Therefore, the subordinated class must absorb credit losses before they can be charged to the senior portion. Because the senior class has this priority claim, cash flows from the underlying pool of assets must first satisfy the requirements of the senior class. Only after these requirements have been met will the cash flows be directed to service the subordinated class.

A more recent form of credit enhancement is the cash collateral account, which is established when a third party deposits cash into a pledged account. The use of cash collateral accounts

^{1.} The Federal Reserve System has developed a threevolume set that contains educational material concerning the process of asset securitization and examination guidelines. The volumes are as follows: (a) An Introduction to Asset Securitization, (b) Accounting Issues Relating to Asset Securitization, and (c) Examination Guidelines for Asset Securitization

Asset Securitization 3030.1

grew as the number of highly rated banks and other credit enhancers declined in the early 1990s. Other forms of credit enhancement include standby letters of credit, pool insurance, or surety bonds from third parties.

An investment banking firm or other organization generally serves as an underwriter for ABS. In addition, for asset-backed issues that are publicly offered, a credit rating agency will analyze the policies and operations of the originator and servicer as well as the structure, underlying pool of assets, expected cash flows, and other attributes of such securities. Before assigning a rating to the issue, the rating agency will also assess the extent of loss protection provided to investors by the credit enhancements associated with the issue.

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

The Structure Of Different Types Of ABS

Asset securitization involves different types of capital market instruments. These instruments may be structured as *pass-throughs or pay-throughs*. Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis. This type of security may be a single-class instrument such as a GNMA pass-through or a multi-class instrument such as a real estate mortgage investment conduit (REMIC).²

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

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

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

 Loan servicing rights—these instruments are created when organizations purchase or originate loans, sell or securitize the loans, and retain the right to act as servicers for pools of loans. The cost of these purchased servicing rights may be recorded as an intangible asset when certain criteria are met. In addition, servicing rights are created when organiza-

^{2.} In the early 1980s, collateralized mortgage obligations

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

3030.1 Asset Securitization

tions purchase the right to act as servicers for loan pools.

- Excess servicing fee receivables —These
 instruments generally arise when the present
 value of any additional cash flows from the
 underlying assets that a servicer expects to
 receive exceeds standard servicing fees.
- ABS residuals (sometimes referred to as residuals or residual interests)—They represent claims on any cash flows that remain after all obligations to investors and any related expenses have been met. Such excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

SUPERVISORY CONSIDERATIONS

Clear benefits can accrue to banking organizations that engage in securitization activities and invest in ABS. Nonetheless, securitization activities can increase the overall risk profile of the banking organization if the activities are not carried out in a prudent manner. For the most part, the types of risks that financial institutions encounter in the securitization process are identical to those that they face in traditional lending transactions. These involve credit risk, concentration risk, interest-rate risk, including prepayment risk, operational risk, liquidity risk, moral recourse risk, and funding risk. However, because the securitization process separates the traditional lending function into several limited roles such as originator, servicer, credit enhancer, trustee, and investor, the types of risks that a branch will encounter will differ depending on the role it assumes.

As with direct investments in the underlying assets, investors in ABS will be exposed to credit risk, that is, the risk that obligors will default on principal and interest payments. Investors are also subject to the risk that the various parties, for example, the servicer or trustee, in the securitization structure will be unable to fulfill their contractual obligations. Moreover, investors may be susceptible to concentrations of risks across various ABS issues through over-exposure to an organization performing various roles in the securitization process, or as a result of geographic concentrations within the pool of assets providing the cash flows for an individual issue. Also, because the

secondary markets for certain ABS are thin, investors may encounter greater than anticipated difficulties when seeking to sell their securities. Furthermore, certain derivative instruments, such as stripped ABS and residuals, may be extremely sensitive to interest rates and exhibit a high degree of price volatility, and, therefore, may dramatically affect the risk exposure of investors, unless used in a properly structured hedging strategy.

Issuer

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

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

Servicer

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

Asset Securitization 3030.1

Accounting Issues

Asset securitization transactions are frequently structured to obtain certain accounting treatments, which, in turn, affect reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for ABS, a key question is whether the transfer should be treated as a sale of the assets or as a collateralized borrowing, that is, a financing transaction secured by assets. Sales treatment results in the assets being removed from the branch's balance sheet, thus reducing total assets relative to earnings and capital and, thereby, producing higher performance and capital ratios. Treatment of these transactions as financings, however, means that the assets in the pool remain on the balance sheet and the related liabilities are subject to reserve requirements.³

Securitization Of Commercial Paper

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

^{3.} Note, however, that it is the Federal Reserve's Regulation D that defines what constitutes a reservable liability of a depository institution. Thus, although a given transaction may qualify as an asset sale for regulatory reporting purposes, it nevertheless could result in a reservable liability under Regulation D.

Asset Securitization Examination Objectives

Effective date July 1997

Section 3030.2

- 1. To determine if the branch is in compliance with laws, regulations and policy statements.
- To determine if the branch is involved in originating, servicing, providing credit enhancements, serving as a trustee for, or investing in securitized assets.
- To determine that securitization activities are properly managed within the context of the branch's overall risk management techniques.
- To determine that management has an appropriate level of experience in securitization activities.
- To ensure that the branch does not hold any asset-backed securities that are inappropriate, given the size of the branch and the sophistication of its operations, e.g., IOs and POs
- To ensure that all asset-backed securities owned and any assets sold with recourse are properly accounted for on the branch's books and in the branch's regulatory reports.
- To determine that sources of credit risk are understood and properly analyzed and managed without excessive reliance on credit ratings by outside agencies.
- To determine that credit, operational, and other risks are recognized and are addressed through appropriate policies, procedures, management reports, and other controls.
- To determine if officers are operating in conformance with established branch policies and procedures.

- 10. To determine that liquidity and market risks are recognized and the branch is not excessively dependent on securitization as a substitute for funding or as a source of income.
- To determine that steps have been taken to minimize the potential for conflicts of interest due to securitization.
- 12. To determine that possible sources of structural failure in securitization transactions are recognized, and that branch and head office management has adopted measures to minimize the impact of such failures should they occur.
- To determine that branch and head office management is aware of the legal risks and uncertainty regarding various aspects of securitization.
- 14. To determine that concentrations of exposure in the underlying asset pools, in the asset-backed securities portfolio, or in the structural elements of securitization transactions are avoided.
- 15. To determine that all sources of risk are evaluated at the inception of each securitization activity and are monitored on an ongoing basis.
- 16. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations or policy statements have been noted.

Asset Securitization

Examination Procedures

Effective date July 1997

Section 3030.3

These procedures represent a comprehensive list of processes and activities to be reviewed during a full scope examination. The examiner-incharge will establish the general scope of the examination and work with the examination staff to tailor specific areas for review as circumstances warrant. The procedures selected will be based on internal audit comments, previous examination workpapers, a general review of the activity to be examined, and the judgement of the examiner and examiner-in-charge.

- Request a schedule of all asset-backed securities owned by the branch. Reconcile to subsidiary ledgers of the balance sheet and review credit ratings assigned to these securities by independent rating agencies. Determine that the accounting methods and procedures used for these assets, at inception and throughout the carrying life, are appropriate.
- Request and review information on the types and amount of assets that have been securitized by the branch. In addition, request information concerning potential contractual or contingent liability from guarantees, underwriting, and servicing of securitized assets, whether originally securitized by the branch or not.
- 3. Review the branch's policies and procedures to ensure that it follows prudent standards of credit assessment and approval for all securitization exposure. Procedures should include thorough and independent credit assessment of each loan or pool for which it has assumed credit risk followed by periodic credit reviews to monitor performance throughout the life of the exposure. If a branch invests in asset-backed securities, determine whether there is sole reliance upon the conclusions of external rating services when evaluating the securities.
- Determine that rigorous credit standards are applied regardless of the role the branch plays in the securitization process, for example, servicer, credit enhancer, or investor.
- Determine that major policies and procedures, including internal credit review and approval procedures and in-house exposure limits, are reviewed periodically and approved by head office management.

- Determine whether adequate procedures for evaluating the branch's internal control procedures and financial strength of the other institutions involved in the securitization process are in place.
- 7. Obtain the documentation outlining any credit enhancements and the remedies available in the event of a default. In addition, both originators and purchasers of securitized assets should have a prospectus on the issue. Obtaining a copy of the prospectus can be an invaluable source of information; a prospectus generally should contain information on credit enhancement, default provisions, subordination agreements, etc. In addition to the prospectus, obtain the documentation confirming the purchase or sale of a security.
- Ensure that, regardless of the role a branch plays in the securitization process, the documentation for an asset-backed security clearly specifies the limitations of the branch's legal responsibility to assume losses.
- 9. Verify whether the branch, acting as originator, packager, or underwriter, has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. The repurchase of defaulted assets or pools, although not required by the underlying agreement, in effect sets a standard by which a branch could potentially be found legally liable for all sold assets. Review and report any situations in which the branch has repurchased or otherwise reimbursed investors for poor quality assets.
- Evaluate credit risk of asset-backed securities and classify any adverse credit risk. List classified assets and evaluate the impact of the classifications on the overall evaluation of the branch.
- 11. Aggregate securitization exposures with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor when determining compliance with internal credit exposure limits.

- 12. Review the branch's valuation methodology for asset-backed securities to determine if it is appropriate.
- 13. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio and evaluated in the context of the risk management assessment.
- 14. Ensure that, in addition to policies limiting direct credit exposure, a branch has developed exposure limits with respect to particular originators, credit enhancers, trustees, and servicers.
- 15. Review the policies of a branch engaged in underwriting with regard to situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the branch to purchase and hold unsold securities. All potential credit exposure should be within prudential lending limits.
- 16. Ensure that internal systems and controls adequately track the performance and condition of internal exposures and monitor the branch's compliance with internal procedures and limits. In addition, verify that adequate audit trails and internal audit coverage are in place. Ensure that the internal reports are adequate in scope and frequency.
- 17. Determine that management information systems provide:
 - a. A listing of all securitizations in which the branch is involved.
 - b. A listing of industry and geographic concentrations.
 - Information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters.
 - d. Information regarding portfolio aging and performance relative to expectations.
 - e. Periodic and timely information to head office management on the branch's involvement in, and credit exposure arising from, securitization.

- 18. Check whether internal auditors review all facets of securitization on a regularly basis.
- 19. Review policies and procedures for compliance with applicable state and federal lending limits. These requirements must be analyzed to determine whether a particular asset-backed security issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation, if they are issued or guaranteed by an agency or instrumentality of the U.S. government.
- 20. Determine whether the underwriting of asset-backed securities of affiliates are:
 - Rated by an unaffiliated, nationally recognized statistical rating organization.
 - Issued or guaranteed by FNMA, FHLMC, or GNMA, or represent interests in such obligations.
- 21. Determine if purchases of high-risk mortgage-backed securities were made to reduce the overall interest rate risk of the branch. Determine if the branch evaluates and documents at least quarterly whether these securities have reduced its interest rate risk.
- 22. Review and discuss any documentation exceptions, violations, internal control exceptions, and classifications with management and obtain and document management's response.
- 23. Review the branch's liquidity agreements with any asset-backed commercial paper programs and determine whether the agreements have any credit related components. Is the branch required to purchase the assets? Are these assets repurchased from the branch? If the facility is determined to be a commitment, determine whether its maturity is short-term or long-term. Do any of the liquidity agreements contain a material adverse clause or any other credit contingency provision?

Asset Securitization

Internal Controls Ouestionnaire

Effective date July 1997

Section 3030.4

Review the branch's internal controls, policies, practices, and procedures for all aspects of asset securitization. The branch's system should be documented in a complete and concise manner and should include, *where appropriate*, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

POLICIES

- 1. Does the branch employ the services of a securities dealer? If so, does the branch rely solely on the advice of such a dealer when purchasing asset-backed securities for the branch's investment portfolio? Does the branch have staff responsible for reviewing and approving the investment manager's acquisitions? Have minimum criteria been established for selecting a securities dealer?
- To ensure a proper level of supervision over branch activities, has head office management reviewed and ratified asset securitization policies, practices, and procedures that:
 - a. Require an initial thorough and independent credit assessment of each asset pool for which the branch has assumed credit risk as either a participant in the securitization process or as an investor?
 - b. Address the repurchase of assets and other forms of reimbursement to investors by the branch when it is serving as the originator, packager, or underwriter in the event that a default results in losses exceeding any contractual credit enhancement?
 - c. Ensure that the credit, pricing, and servicing standards for securitized assets are equivalent to standards for assets that remain on the branch's books?
 - d. Ensure that the credit, pricing, and servicing standards and compliance with any provisions relating to government guarantees are reviewed periodically by head office management?
 - e. Establish in-house diversification requirements, within proper risk management techniques, regarding aggregate outstanding exposures to a particular institution, industry, or geographic area?

- f. Hedge the branch's exposure to adverse price movements when engaged in underwriting or market-making activities?
- 3. Are securitization policies reviewed and reaffirmed at least annually to determine if they are compatible with changing market conditions?

INTERNAL CONTROL/MANAGEMENT INFORMATION SYSTEMS

- 4. Do the branch's internal systems and controls adequately track the performance and condition of internal exposures, and do the systems monitor the branch's compliance with internal procedures and limits? Are adequate audit trails and internal and external audit coverage provided?
- 5. Do the branch's cost accounting systems provide a reliable determination of the profitability and volatility of asset securitization activities?
- 6. Are management information systems and reporting procedures adequate, in that they:
 - a. Provide a listing of all securitizations for which the branch is originator, servicer, credit enhancer, underwriter, or trustee?
 - b. Provide a listing of industry and geographic concentrations?
 - c. Provide information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters?
 - d. Provide information regarding portfolio aging and performance relative to expectations?
 - e. Provide periodic and timely information to head office management on the branch's involvement in, and credit exposure arising from, securitization?
 - f. Provide credit ratings assigned by independent rating agencies to all assetbacked securities held by the branch?

CONCLUSION

7. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.

8. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Effective date July 1997

One method of financing international trade is by the use of a banker's acceptance. Such an instrument may be used to finance all of the successive stages of the movement of goods through the channels of trade from the point of origin to the final destination.

A banker's acceptance is an order in the form of a time draft (also referred to as a bill of exchange or a usance draft) drawn by one party (the drawer) in favor of itself or another party (the payee), addressed to (drawn on) a bank (the drawee) and accepted by that bank to pay the holder a certain sum on or before a specified date. The bank's acceptance of this order from the drawer, by stamping across the face of the draft ACCEPTED and dating and signing the stamp, is a formal acknowledgement of the obligation and constitutes an unconditional promise by that bank to honor the time draft at maturity. The drawee bank creating the acceptance is primarily liable for the instrument, while the payee, as first endorser, is secondarily liable for paying the holder in due course. If the drawee (acceptor) is other than a bank, the instrument is a trade acceptance, not a banker's acceptance.

Most banker's acceptances are used to finance trade transactions. Accordingly, acceptances are often created in connection with a letter of credit, although they may arise in connection with collection or open account transactions. Refer to the manual section entitled Letters of Credit. In general, acceptance credit is considered self-liquidating in that it provides the means for its own payment at maturity. Self-liquidation is accomplished because the acceptance must be based on a specific trade transaction in which goods are being shipped prior to entering the channels of trade. Therefore, satisfactory evidence should be available indicating that the draft, when created, is based on an actual shipment or storage. Furthermore, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

The payee of the acceptance may hold an acceptance until maturity, discount it with his or her bank, or sell it in the acceptance market. When a bank discounts (purchases) its own acceptance for the payee, its Customers' Liability on Acceptances (asset) and Bank's Liability

on Acceptances (liability) accounts are reduced and the discounted acceptance is recorded with other loans and discounts. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, that acceptance is rebooked as Customers' Liability on Acceptances and Bank's Liability on Acceptances outstanding and the loan and discount account is reduced. Rediscounted acceptances are not considered borrowings. The customer's liability on acceptances is reduced by a customer's prepayment or anticipation, of an acceptance outstanding. However, the bank's liability is not similarly reduced by an anticipation.

The established market for banker's acceptances in the United States is regulated by the Federal Reserve System. Federal Reserve Banks are authorized to discount or purchase eligible banker's acceptances subject to qualitative and quantitative limits, thus providing a source of liquidity to the selling banks. The creation of banker's acceptances is governed by Section 13 of the Federal Reserve Act (12 USC 372), which establishes criteria that must be met in order for the instrument to be eligible for either discount or purchase by the Federal Reserve Banks. In addition, for federally-licensed branches, the eligible banker's acceptance limit is in addition to the loan and investment securities limits. The rules governing whether an acceptance meets the eligibility requirements for discount or purchase are important for two major reasons. First, acceptances meeting the conditions of eligibility are more readily salable in the market than are acceptances that do not satisfy these conditions and, as such, provide a greater degree of liquidity for the accepting bank. Second, unlike eligible acceptances, ineligible acceptances are subject to reserve maintenance requirements, thus raising the cost to the borrower over that of an eligible acceptance. For federally-licensed branches, ineligible banker's acceptances are subject to the limits specified in 12 USC 84 and are combined with loans. The examiner must be familiar with the criteria used for determining eligibility for discount or purchase by the Federal Reserve Banks.

Branches that are subject to reserve requirements (i.e. controlled by an entity with \$1 billion in total worldwide consolidated assets) under Section 7 of the International Banking Act of 1978 (12 USC 3105(a)) are subject to the limitations described in Section 13 of the Fed-

eral Reserve Act (12 USC 372). These regulations limit the amount of eligible banker's acceptances that may be created to 150 percent (or 200 percent with the permission of the Board) of the paid up and unimpaired capital stock and surplus of the foreign banking organization (FBO). In addition, all U.S. branches of an FBO are prohibited from creating eligible banker's acceptances for any one person in the aggregate in excess of 10 percent of the FBO's capital. Eligible banker's acceptances growing out of domestic transactions are not to exceed 50 percent of the aggregate of all eligible acceptances authorized for a branch.

Banker's acceptances, as a source of finance and investment, offer significant advantages to borrowers, accepting banks, and investors alike. Over the years, a banker's acceptance has often been a cheaper financing vehicle than a loan, because it is readily marketable, is considered an important secondary reserve for the accepting bank, and is a relatively secure investment to the investor because of its two-name backing.

Banker's Acceptances Examination Objectives

Effective date July 1997

Section 3040.2

- To determine if objectives, policies, practices, procedures, and internal controls regarding banker's acceptances are adequate.
- 2. To determine if branch officers are operating in conformance with the established guidelines.
- To determine the scope and adequacy of the audit function as it applies to banker's acceptances.
- To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
- 5. To determine compliance with applicable federal and state laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Banker's Acceptances Examination Procedures

Effective date July 1997

Section 3040.3

- If selected for implementation, complete or update the Internal Control Questionnaire for this section.
- Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
- Review the bankers acceptance section of the lending policy for adequacy.
- 4. Check scope of internal audit to ensure that it covers a review of bankers acceptances.
- 5. Reconcile balances to departmental controls and the general ledger.
- Verify that appropriate accounting methods are used and that regulatory reports are accurately prepared.
- 7. Determine that there is appropriate segregation of duties in that:
 - a. Individuals who prepare and post BA records also do not issue official checks or handle cash.
 - Individuals who perform reconciliations and certifications also do not process acceptances, and
 - Persons who investigate exceptions and respond to inquiries do not normally process acceptances.
- 8. Ensure the branch has an adequate system to track outstanding exceptions and delinquencies.
- Ensure that acceptances are registered in some manner (manual log book or computer system), consecutively numbered, and identified by type of transaction so as to leave an audit trail.
- Review procedures for safeguarding blank, accepted, and pre-signed documents and drafts.
- 11. Review procedures for determining BA eligibility. Ensure that ineligible acceptances are appropriately segregated from the elibible acceptances. Ineligible acceptances cannot be discounted at the Federal Reserve and are treated as reservable liabilities.

Eligibility can be determined by reviewing documentary evidence detailing the nature of the transaction underlying the credit extended. This evidence may be in the form of correspondence, title documents, or document transmittal letters that provide sufficient detail to judge

eligibility according to established criteria. Details provided should cover:

- Value of merchandise.
- Description of merchandise.
- Origin and destination of shipment.
- Date of shipment.
- Certification that the merchandise is not being financed elsewhere.
- 12. Review procedures for financing clean acceptances (i.e. when the title and shipping documentation is not processed by the office) to ensure they include:
 - a. Details of the shipment such as invoice amount, type of commodity or merchandise, ports of embarkation and debarkation, and the bill of lading date.
 - b. Certification that duplicate financing does not exist.
 - An agreement by the customer to provide copies of invoices and bills of lading to the branch upon request.
- 13. Review procedures for monitoring the stipulated aggregate liability limitations on outstanding acceptances. Systems should be in place to monitor the global customer exposure on the aggregate outstanding amount on a consolidated basis which cannot exceed 150% of parent bank capital.
- 14. Select a sample of bankers acceptances created for specific borrowers and review credit files for credit risk. Forward findings to examiner in charge of loan review.
- Ensure the branch has procedures in place to comply with OFAC and Anti-Boycott provisions.
- 16. Prepare, in appropriate format, the findings and conclusions regarding:
 - a. The adequacy of policies relating to banker's acceptances.
 - b. Whether branch officers are operating in conformance with established policy.
 - c. Adverse trends within the banker's acceptance department.
 - d. The accuracy and completeness of the schedules obtained.
 - e. Internal control deficiencies or exceptions.
 - Recommended corrective action when policies, practices, or procedures are deficient.

- g. Other matters of significance.

 17. Update the workpapers with any information that will facilitate future examinations.

Banker's Acceptances Internal Control Questionnaire

Effective date July 1997

Section 3040.4

POLICIES

- 1. Have policies been adopted that:
 - a. Establish procedures for reviewing banker's acceptance applications?
 - b. Define qualified customers?
 - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
- 2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

- 3. Is the preparation and posting of subsidiary banker's acceptance records performed or reviewed by persons who do not also handle cash or issue official checks or drafts?
- 4. Are the subsidiary banker's acceptance records balanced daily with the appropriate general ledger accounts and are reconciling items adequately investigated by persons who do not normally handle acceptances and post records?
- 5. Are acceptance delinquencies prepared for and reviewed by management on a timely basis?
- 6. Are inquiries about acceptance balances received and investigated by persons who do not normally handle settlements or post records?
- 7. Are bookkeeping adjustments checked and approved by an appropriate officer?
- 8. Is a daily record maintained, summarizing acceptance transactions details, i.e., banker's acceptances created, payments received, and fees collected, to support applicable general ledger account entries?
- 9. Are acceptances of other banks that have been purchased in the open market segregated on the branch's records from the branch's own acceptances purchased?
- 10. Are prepayments on banker's acceptances netted against the appropriate asset account Customer Liability for Acceptances Outstanding (or loans and discounts, depending upon whether the branch has discounted its own acceptance), and do they continue to

- be shown as a liability under Bank's Liability on Acceptances Outstanding?
- 11. Are banker's acceptance record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record acceptance transactions?

FEES

- 12. Is the preparation and posting of fees and discounts performed or reviewed by persons who do not also handle cash or issue official checks or drafts?
- 13. Are any independent fee and discount computations made and compared or adequately tested to initial fee and discount records by persons who do not also handle cash or issue official checks or drafts?

OTHER

- 14. Are acceptance record copies, own acceptances discounted (purchased) and acceptances of other banks purchased safeguarded during banking hours, locked in the vault overnight, and periodically inventoried?
- 15. Are blank (pre-signed) customer drafts maintained under dual control in the vault, numbered, inventoried monthly, and verified with the customer on a monthly basis?
- 16. Are any acceptance fee rebates approved by an officer?
- 17. Does the branch have an internal review system that:
 - a. Reviews collateral and supporting documentation held for negotiability and proper assignment?
 - b. Test checks the values assigned to collateral at frequent intervals?
 - Determines that lending officers are periodically advised of maturing banker's acceptances or acceptance lines.
 - d. Determines that the individuals to whom funds are being disbursed are authorized by the beneficiary to receive the funds?
 - e. Addresses funding procedures for rediscounted acceptances?

- f. Tests for compliance with **IBF** restrictions?
- 18. Does the branch's acceptance filing system provide for the identification of each acceptance, e.g., by consecutive numbering and applicable letter of credit, to provide a proper audit trail?
- ing internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 20. Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

CONCLUSION

19. Is the information covered by this internal control questionnaire adequate for evaluatGenerally, commercial loans comprise the largest asset concentration of a branch, offer the most complexity, and require the greatest commitment from branch management to monitor and control risks. Proper management of these assets requires a clearly articulated credit policy that imposes discipline and sound loan administration. Since lenders are subject to pressures related to productivity and competition, they may be tempted to relax prudent credit underwriting standards to remain competitive in the marketplace, thus increasing the potential for risk. Examiners need to understand the unique characteristics of the varying types of commercial and industrial loans, as well as how to properly analyze their quality.

Commercial loans are extended on a secured or unsecured basis with a wide range of purposes, terms, and maturities. While the types of commercial and industrial loans can vary widely depending on the purpose of loans made and market characteristics where the branch operates, most commercial and industrial loans will primarily be made in the form of a working-capital loan, term loan, or loan to an individual for a business purpose. This section will provide examiners with a fundamental understanding of secured and unsecured transactions, the key principles for assessing credit quality, and basic bankruptcy law. Other sections of this manual discuss more specific types of lending.

TYPES OF COMMERCIAL LOANS

Working Capital or Seasonal Loans

Working capital or seasonal loans provide a business with short-term financing for inventory, receivables, the purchase of supplies, or other operating needs during the business cycle. These types of loans are often appropriate for businesses that experience seasonal or short-term peaks in current assets and current liabilities, such as a retailer who relies heavily on a holiday season for sales or a manufacturing company that specializes in summer clothing. These types of loans are often structured in the form of an advised line of credit or a revolving credit. An advised line of credit is a revocable commitment by the branch to lend funds up to a specified period of time, usually one year. Lines

of credit are generally reviewed annually by the branch, do not have a fixed repayment schedule, and may not require fees or compensating balances. In the case of unadvised lines of credit. the branch has more control over advances and may terminate the facility at any time, depending on state law or legal precedents. A revolving line of credit is valid for a stated period of time and does not have a fixed repayment schedule, but usually has a required fee. The lender has less control over a revolving credit since there is an embedded guarantee (i.e. firm commitment) to make advances within the prescribed limits of the loan agreement. The borrower may receive periodic advances under the line of credit or the revolving credit up to the agreed limit. Repayment is generally accomplished through the conversion or turnover of short-term assets, such as inventory or accounts receivable. Interest payments on working capital loans are usually paid throughout the term of the loan, such as monthly or quarterly.

Working-capital loans are intended to be repaid through the cash flow derived from converting the financed assets to cash. The structure of the loans can vary, but they should be closely tied to the timing of the conversion of the financed assets. In most cases, working-capital facilities are renewable at maturity, are for a one-year term, and include a clean-up requirement for a period sometime during the low point or contraction phase of the business cycle. The clean-up period is a specified period (usually 30 days) during the term of the loan in which the borrower is required to pay off the loan. While this requirement is becoming less common, it provides the branch with proof that the borrower is not dependent on the lender for permanent financing. It is important to note, however, that an expanding business may not be able to clean up its facility since it may be increasing its current assets.

Analysis of Working-Capital Loans

The analysis of a working-capital loan is best accomplished by a monthly or quarterly review of a company's balance sheet and income statements to identify the peak and contraction phases of the business cycle. The lender should know when the peak and contraction phases are, and

3050.1 Commercial Loans

the loan should be structured accordingly. The lender's primary objective is to determine whether the advances are being used for the intended purposes (inventories or payables) and not for the acquisition of fixed assets or payments on other debts. Repayments on the facility should also be consistent with the conversion of assets. If the borrower has other loan facilities at the branch, all credit facilities should be reviewed at the same time to ensure that the activity with the working-capital facility is not used to pay interest on other loans in the branch. Projections of sources and uses of funds are also a valuable tool for reviewing a working-capital line of credit and determining the sales cycle.

Quarterly balance-sheet and income statements are very helpful when a comparison is made with the original projections. Other helpful information can be obtained from a review of an aging of accounts receivable for delinquencies and concentrations, a current list of inventory, an accounts-payable aging, and accruals made during the quarter. This information can be compared with the outstanding balance of the facility to ensure that the loan is not overextended and that the collateral margins are consistent with borrowing-base parameters.

A borrowing base is the amount the lender is willing to advance against a dollar value of pledged collateral; for example, a branch will only lend up to a predetermined specified percentage of total outstanding receivables less all accounts more than a certain number of days delinquent. A borrowing-base certificate should be compiled at least monthly or more often during peak activity in the facility. When reviewing working-capital loans, examiners should remember that a branch relies heavily on inventory as collateral in the beginning of a company's business cycle and on receivables toward the end of the business cycle. However, in traditional working-capital loans, greater emphasis is usually placed on accounts receivable as collateral throughout the loan's tenure.

Normally, a branch is secured by a perfected blanket security interest on accounts receivable, inventory, and equipment, and on the proceeds from the turnover of these assets. Well-capitalized companies with a good history of payout or cleanup may be exceptions and qualify for unsecured lending. An annual lien search, however, would be prudent under this type of lending relationship to detect any purchase money security interest that may have occurred during the business cycle.

The following are potential problems associated with working-capital loans:

- Working-capital advances used for funding losses. A business uses advances from a revolving line of credit to fund business losses, including the funding of wages, business expenses, debt service, or any other cost not specifically associated with the intended purpose of the facility.
- Working-capital advances funding long-term assets. A business will use working-capital funds to purchase capital assets that are normally acquired with term business loans.
- Trade creditors not paid out at end of business cycle. While the branch may be paid out, some trade creditors may not get full repayment. This can cause a strained relationship as unpaid trade creditors may be less willing to provide financing or offer favorable credit terms in the future. In turn, the business will become more reliant on the branch to support funding needs that were previously financed by trade creditors.
- Overextension of collateral. The business does not have the collateral to support the extension of credit, causing an out-of-borrowing-base situation. Examiners should review borrowingbase certificates to verify that coverage meets the prescribed limitations established by the branch's credit policy for the specific assets being financed.
- Value of inventory declines. When a business
 does not pay back the branch after inventory is
 converted to cash or accounts receivable, the
 value of the inventory declines. Other causes
 of inventory devaluation include obsolescence, a general economic downturn, or in the
 case of a commodity, market volatility.
 Declines in inventory value will commonly
 put a working-capital facility in an out-ofborrowing-base situation and require the
 excess debt to be amortized and repaid through
 future profits of the business.
- Collectibility of accounts receivable declines.
 The increasingly past-due status of accounts receivable or deteriorating credit quality of account customers both result in the noncollection of receivables. This can also cause an out-of-borrowing-base situation for the lending institution.
- Working-capital advances used to fund longterm capital. Funds may be inappropriately used to repurchase company stock, pay off

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subordinated debt holders, or even pay dividends on capital stock.

These situations may cause a loan balance to be remaining at the end of the business cycle. If this should occur, the branch generally has one of three options: (1) Require the unpaid balance to be amortized; This option is, however, dependent on the ability of the business to repay the debt through future profits; (2) Request the borrower to find another lender or require an infusion of capital by the borrower. This is not always a feasible option because of the probable weakened financial condition of the business and ownership under these circumstances; or (3) Liquidate the collateral. Foreclosing on the collateral should only be executed when it becomes obvious that the business can no longer function as a going concern. The problem with this option is that once the branch discovers that the business is no longer a viable concern, realizing the full value of the collateral is in jeopardy. The need to resort to any of these options will usually prompt criticism of the credit.

Term Loans

Term loans are generally granted at a fixed or variable rate of interest, have a maturity in excess of one year, and are intended to provide an organization with the funds needed to acquire long-term assets, such as physical plants and equipment, or finance the residual balance on lines of credit or long-term working capital. Term loans are repaid through the business's cash flow, according to a fixed-amortization schedule, which can vary based on the cash-flow expectations of the underlying asset financed or the anticipated profitability or cash flow of the business. Term loans involve greater risk than short-term advances because of the length of time the credit is extended. As a result of this greater risk, term loans are usually secured. Loan interest may be payable monthly, quarterly, semiannually, or annually. Loan principal should amortize with the same frequency in order to fully pay off the loan at maturity.

In most cases, the terms of these loans are detailed in formal loan agreements with affirmative and negative covenants that place certain conditions on the borrower throughout the term of the loan. In affirmative covenants, the bor-

rower pledges to fulfill certain requirements, such as maintain adequate insurance coverage, make timely loan repayments, or ensure the financial stability of the business. Negative or restrictive covenants prohibit or require the borrower to refrain from certain practices, such as selling or transferring assets, defaulting, falling below a minimum debt coverage ratio, exceeding a maximum debt-to-equity ratio, or taking any action that may diminish the value of collateral or impair the collectibility of the loan. Covenants should not be written so restrictively that the borrower is constantly in default over trivial issues; however, violations should be dealt with immediately to give credibility to the agreement. Violations of these covenants can often result in acceleration of the debt maturity and payments. A formal loan agreement is most often associated with longer-term loans. If a formal agreement does not exist, the term loans should be written with shorter maturities and balloon payments to allow more frequent review by branch management.

Analysis of Term Loans

While a working-capital loan analysis emphasizes the balance sheet, the analysis of term loans will focus on both the balance sheet and the income statement. Because a term loan is repaid from excess cash flow, the long-term viability of the business is critical in determining the overall quality of the credit. In evaluating long-term earnings, the examiner must develop a fundamental understanding of the company's industry and competitive position in the marketplace. Most of the analysis will be conducted based on the historical performance of the business and its history of making payments on its debt. Any historical record of inconsistencies or inability to perform on existing debt should prompt an in-depth review to determine the ability of the borrower to meet the loan's contractual agreements. One of the most critical determinations that should be made when evaluating term debt is whether the term of the debt exceeds the useful life of the underlying asset being financed.

While cash flow of the business is the primary source of repayment for a term loan, a secondary source would be the sale of the underlying collateral. Often, if circumstances warrant a collateral sale, the branch may face steep dis3050.1 Commercial Loans

counts and significant expenses related to the sale. Examiners should carefully consider these issues when evaluating the underlying value of collateral under a liquidation scenario.

The following are potential problems associated with term loans:

- The term of the loan is not consistent with the useful life of collateral.
- Cash flow from operations does not allow for adequate debt amortization, a fundamental problem that can be solved only by improved performance.
- The gross margin of the business is narrowing, which requires the business to sell more product to produce the same gross profit.
 Higher sales volume could require more cash for expansion of current assets, leaving less cash for debt amortization. This situation is a common by-product of increased competition.
- Sales are lower than expected. In the face of lower sales, management is unable or unwilling to cut overhead expenses, straining cash flow and resulting in diminished debt servicing ability.
- Fixed assets that are financed by term loans become obsolete before the loans are retired, likely causing the value of underlying collateral to deteriorate.
- The business's excess cash is spent on higher salaries or other unnecessary expenses.
- The payments on term debt have put a strain on cash flow, and the business is unable to adequately operate or allow natural expansion.
- The balance sheet of the business is weakening. The overall financial condition of the business is deteriorating because of poor performance or unforeseen occurrences in the industry.

Shared National Credits

Regulatory agencies participate in a program for the uniform review of shared national credits (SNC). A SNC is defined as any loan, commitment, or group of loans or commitments aggregating \$20 million or more at origination that is:

- Committed under a formal lending arrangement.
- Shared at its inception by two or more supervised institutions or sold to one or more

institutions with the purchasing entity assuming its pro rata share of the credit risk.

A single facility with different terms and/or participants for tranches should be reported as separate credits. Loans sold to affiliate banks of the same holding company are not part of the SNC program.

If the outstanding balance or commitment of a SNC falls below \$20 million after its inception, and it is not criticized, the credit will not be reviewed at the next review date. Therefore, the examiner should conduct an individual review of the credit at the branch under examination. However, if the former SNC facility fell below the threshold through a charge-off, and was classified or specially mentioned at the most recent SNC review, the credit relationship would continue to be reviewed under the SNC program until such time that the balance falls below \$10 million. The Federal Deposit Insurance Corporation (FDIC), the state agencies, and the Office of the Comptroller of the Currency (OCC) also participate in this program. The Federal Reserve carries out the examination of SNCs at the lead or agent banks that are state-member banks, state-chartered foreign branches, and credit-extending nonbank subsidiaries of domestic and foreign organizations. The FDIC is primarily responsible for any SNC credits at state non-member banks, and the OCC supervises the review of those SNCs in which the lead bank is a national bank or an OCC-chartered foreign branch.

SNCs should not be analyzed or reviewed during the examination of the individual participating branch. If the examiner is uncertain whether the credit was reviewed under the SNC program, the respective Reserve Bank coordinator should be contacted. If credits eligible for the program are found but have not been reviewed (other than new SNCs since the time of the last SNC program review), the examiner should submit a memorandum detailing those credits to the respective Reserve Bank coordinator to be forwarded to the SNC coordinator at the Federal Reserve Bank of New York.

The SNC program does not track subparticipations. A subparticipant is a banking organization that has purchased a share from either a bank in the original syndicate or from a bank considered a first-tier participant. Therefore, if the bank is a subparticipant in a credit, it will not appear in the "Report of Lenders and their Borrowers". However, the credit may have been

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reviewed by the SNC Program and examiners can obtain the results of such a review by calling the SNC coordinator for their agency.

SECURED AND UNSECURED TRANSACTIONS

This subsection is intended to be a general reference for an examiner's review of a credit file to determine whether the branch's collateral position is properly documented. Examiners should be aware that secured transactions encompass an extensive body of law that is rather technical in nature. The following discussion contains general information for examiners on the basic laws that govern a branch's security interest in property and on the documentation that needs to be in a loan file to properly document a perfected security interest in a borrower's assets.

Secured Transactions

Most secured transactions in personal property and fixtures are governed by article 9 of the Uniform Commercial Code (UCC). The UCC has been adopted by all 50 states, the District of Columbia, and the Virgin Islands. Timing differences as well as filing locations differ from state to state. Failure to file a financing statement in a timely manner or in the proper location will compromise a lender's security interest in the collateral.

Article 9 of the UCC applies to any transaction that is intended to create a security interest in personal property. Mortgage transactions are not covered, marine mortgages are filed with the Coast Guard, and aircraft liens are filed with the Federal Aviation Administration. A *security interest* is defined in the UCC as "an interest in personal property or fixtures which secures payment or performance of an obligation." A secured transaction requires that there be an agreement between the parties indicating the parties' intention to create a security interest for the benefit of the creditor or secured party. This agreement is commonly referred to as a security agreement.

Article 9 of the UCC refers to two different concepts related to security interests: attachment and perfection. *Attachment* is the point in time at

which the security interest is created and becomes enforceable against the debtor. Perfection refers to the steps that must be taken in order for the security interest to be enforceable against third parties who have claims against collateral.

Attachment of Security Interest

The three requirements for the creation of a security interest are stated in UCC section 9-203(1). Once the following requirements are met, the security interest is attached.

- The collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement that contains a description of the collateral and, when the security interest covers crops now growing or to be grown or timber to be cut, a description of the land concerned.
- · Value has been given to the debtor.
- The debtor has rights in the collateral.

Thus, unless the collateral is in the possession of the secured party, there must be a written security agreement that describes the collateral. The description does not have to be very specific or detailed— "any description of personal property... is sufficient whether or not it is specific if it reasonably identifies what is described" (see UCC section 9-110). The agreement must also be signed by the debtor. The creditor may sign it, but its failure to do so does not affect the agreement's enforceability against the debtor.

Giving value is any consideration that supports a contract. Value can be given by a direct loan, a commitment to grant a loan in the future, the release of an existing security interest, or the sale of goods on contract.

While the debtor must have *rights* in the collateral, he or she does not necessarily have to have title to the property. For example, the debtor may be the beneficiary of a trust (the trustee has title of trust assets) or may lease the collateral. The debtor, in such cases, has rights in the collateral, but does not hold the title to the collateral. The secured party, however, only obtains the debtor's limited interest in the collateral on default if the debtor does not have full title to the collateral.

Perfection of Security Interest in Property

Perfection represents the legal process by which a creditor secures an interest in property. Perfection provides the branch assurance that it has a legal interest in the collateral. The category of collateral will dictate the method of perfection to be used. The most common methods of perfection are: (1) automatic perfection when the security interest is attached (such as in the case of purchase-money security interests applicable to consumer goods other than vehicles); (2) perfection by possession; (3) the filing of a financing statement in one or more public filing offices,1 and (4) compliance with a state certificate of title law or central filing under a state statute other than the UCC, such as registration of vehicles.

The most common method of perfecting a security interest is public filing. Public filing serves as a constructive notice to the rest of the world that the branch claims a security interest in certain property of the debtor described in both the security agreement and the financing statement. Public filing is accomplished by filing a financing statement (UCC-1) in a public office, usually the county recorder or secretary of state. The system of filing required by the UCC provides for a notice filing whereby potential creditors can determine the existence of any outstanding liens against the debtor's property.

The form of the financing statement and where to file it varies from state to state. While the filing of a nonstandard form will generally be accepted, the failure to file in the proper public office can jeopardize the priority of the lender's security interest. The UCC provides three alternative filing systems:

- Alternative System One. Liens on minerals, timber to be cut, and fixtures are filed in the county land records. All other liens are filed in the office of the secretary of state.
- Alternative System Two. The majority of states have adopted this version. It is the same as system one, except liens on consumer goods, farm equipment, and farm products are filed in the county where the debtor resides, or in the

- county where the collateral is located if it is owned by a nonresident.
- Alternative System Three. In a few states, filings made with the secretary of state must also be filed in the county of the borrower's business (or residence if there is no place of business in that state). Otherwise, the requirement in these states is the same as system two.

As each state may select any of the above three alternatives or a modified version of them, it is important that the examiner ascertain the filing requirements of the state(s) where the branch's customer operates. Most importantly, it is the location of the borrower, not the branch, that determines where the financing statement must be filed.

Evaluation of Security Interest in Property

Key items to look for in evaluating a security interest in property include the following:

- Security agreement. There should be a proper security agreement, signed and dated by the borrower, that identifies the appropriate collateral to be secured. It should include a description of the collateral and its location in sufficient detail so the lender can identify it, and should assign to the lender the right to sell or dispose of the collateral if the borrower is unable to pay the obligation.
- Collateral possession. If the institution has taken possession of the collateral to perfect its security interest, management of the institution should have an adequate record-keeping system and proper dual control over the property.
- Financing statement. If the institution has filed a financing statement with the state or local authority to perfect its security interest in the collateral, in general, it should contain the following information:
 - names of the secured party and debtor
- the debtor's signature
- the debtor's mailing address
- the address of the secured party from which information about the security interest may be obtained
- the types of the collateral and description of the collateral²

^{1.} The financing statement is good for five years, and the lender must file for a continuation within the six-month period before expiration of the original statement.

^{2.} Substantial compliance with the requirements of UCC

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- Amendments. Not all amendments require the borrower's signature, and branches may file an amendment for the following reasons:
 - borrower's change of address
 - creditor's change of address
 - borrower's name change
 - creditor's name change
 - correction of an inaccurate collateral description
 - addition of a trade name for the borrower that was subsequently adopted
- Where to file a financing statement. In general, financing statements filed in good faith or financing statements not filed in all of the required places are still effective. If a local filing is required, the office of the recorder in the county of the debtor's residence is the place to file. If state filing is required, the office of the secretary of state is the place to file.
- Duration of effectiveness of a financing statement. Generally, effectiveness lapses five years after filing date. If a continuation statement is filed within six months before the lapse, effectiveness is extended five years after the last date on which the filing was effective. Succeeding continuation statements may be filed to further extend the period of effectiveness.

Perfection of Security Interest in Real Estate

As previously mentioned, real estate is expressly excluded from coverage under the UCC. A separate body of state law covers such interests. However, for a real estate mortgage to be enforceable, the mortgage must be recorded in the county where the real estate covered by the mortgage is located.

Real estate mortgage/deed of trust. When obtaining a valid lien on real estate, only one document is used, the mortgage or deed of trust. The difference between a mortgage and a deed of trust varies from state to state; however, the primary difference relates to the process of foreclosure. A mortgage generally requires a

section 9-402 is sufficient if errors are only minor and not seriously misleading. Some states require the debtor's tax ID number on the financing statement.

judicial foreclosure, whereas, in some states, a foreclosure on a deed of trust may not. Nearly all matters affecting the title to the real estate, including the ownership thereof, are recorded in the recorder's office.

When determining the enforceability of a real estate mortgage or deed of trust, the examiner should be aware of the following requirements:

- The mortgage must be in writing.
- To be recordable, the mortgage must be acknowledged. There are different forms of acknowledgments for various situations depending on whether individuals, corporations, partnerships, or other entities are executing the mortgage. Make sure that the form of the acknowledgment used is in accordance with the type of individual or entity executing the mortgage.
- If a corporation is the mortgagor, its articles of incorporation or bylaws often will specifically state which officers have authority to sign an instrument affecting real estate. In these instances, the designated officer should be required to sign. If the corporation has a seal, that also must be affixed. If the corporation does not have a seal, this fact must be shown in the acknowledgment.
- As soon as possible after the mortgage is executed, it should be recorded in the office of the recorder for each county in which the property described in the mortgage is located. In most cases, the borrower signs an affidavit that indicates, in part, that he or she will not attempt to encumber the property while the lender is waiting for the mortgage to be recorded. In any event, the lender should conduct a title search after the mortgage is recorded to ensure that his position has not been compromised.
- If the mortgagor is married, the spouse must join in the execution of the mortgage to subject his or her interest to the lien of the mortgage. If the mortgagor is single, the mortgage should indicate that no spouse exists who might have a dower interest or homestead interest in the property.
- If the mortgagor is a partnership, it must be determined whether the title is in the name of the partnership or in the names of the individual partners. If the title is in the names of the individual partners, their spouses should join in executing the mortgage. If the title is in the name of the partnership, those partners

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who are required to sign under the partnership agreement should sign.

Unsecured Transactions

Unsecured transactions are granted based on the borrower's financial capacity, credit history, earnings potential, and/or liquidity. Assignment of the borrower's collateral is not required, and repayment is based on the terms and conditions of the loan agreement. While unsecured loans often represent the branch's strongest borrowers, the unsecured loan portfolio can represent its most significant risk. One of the primary concerns related to unsecured credit is that if the borrower's financial condition deteriorates, the lender's options to work out of the lending relationship deteriorate as well. In general, if a credit is unsecured, the file should contain reliable and current financial information that is sufficient to indicate that the borrower has the capacity and can be reasonably expected to repay the debt.

Emerging Problem Loans

The following are key signals of an emerging problem loan:

- Outdated or inaccurate financial information. The borrower is unwilling to provide the financial institution with a current, complete, and accurate financial statement at least annually. Management also should request a personal tax return (and all related schedules) on the borrower. While borrowers will usually present their personal financial statements in the most favorable light, their income tax return provides a more conservative picture.
- The crisis borrower. The borrower needed the money yesterday, so the branch advanced unsecured credit.
- No specific terms for repayment. The unsecured loan has no structure for repayment, and it is commonly renewed or extended at maturity.
- Undefined source of repayment. Repayment sources are often not identified and are unpredictable. These types of loans are often repaid through excess cash flow of the borrower, sale of an asset(s), or loan proceeds from another financial institution.

REVIEWING CREDIT QUALITY

Importance of Cash Flow

Evaluating cash flow is the single most important element in determining whether a business has the ability to repay debt. Two principal methods of calculating the cash flow available in a business to service debt are presented in this subsection. The results of these methods should be used to determine the adequacy of cash flow in each credit evaluated at an institution. The accrual conversion method is the preferred method because it is the most reliable. The second and less reliable method is the supplemental or traditional cash-flow analysis; however, the information needed for this analysis is usually more obtainable and easier to calculate. The traditional method can be used when circumstances warrant, for example, when the borrower's financial statements are not sufficiently detailed for the information requested in the accrual conversion analysis or when historical information is inadequate.

Analysis and Limitations of Cash Flow

Cash-flow analysis uses the income statement and balance sheet to determine a borrower's operational cash flow. Careful analysis of all investment and financing (borrowing) activities must be made for an accurate assessment of cash flow. In reality, examiners face time constraints that often prevent them from performing the complex mathematical calculations involved in sophisticated cash-flow analysis. Therefore, the cash-flow methods presented below were designed to be reasonable and practical for examiner use. However, examiners should be careful of conclusions reached using the traditional cash-flow analysis, without consideration of balance-sheet changes or other activities that affect cash flow. The traditional cash-flow analysis does not recognize growth in accounts receivable or inventory, a slow-down in accounts payable, capital expenditures, or additional borrowings. If the credit file contains a CPAprepared statement of cash flow or a statement prepared using the accrual conversion method, the examiner should concentrate efforts on reviewing and analyzing these statements rather Commercial Loans 3050.1

than on preparing a traditional cash-flow statement.

One critical issue to remember is that deficit cash flow does not always mean that the borrower is encountering serious financial difficulties. In some cases, deficit cash flow is caused by a business's experiencing significant growth, and there is a pronounced need for external financing to accommodate this growth and eliminate the deficit cash-flow position. In this case, an adequate working-capital facility may not be in place to accommodate the need for additional inventory. A comprehensive analysis of changes in the balance sheet from period to period should be made before the loan is criticized.

Components of the Accrual Conversion Method of Cash Flow

Basis for Amount Category Cash Flow before Debt Service: Sales: Dollar amount of sales in period +/-change in A/R, INV., A/P: Represents the absolute difference of the current period from the corresponding period of the Debt Service: previous year in accounts receivable, inventory, accounts payable. Capital Expenditures: Formula: a) An increase in any current asset is a use of cash and is subtracted from the calculation. EQUALS— Conversely, a decrease in any Excess (Deficit) current asset is a source of cash Cash Flow: and is added to the calculation. b) An increase in any current liability is a source of cash and Coverage is added to the calculation. Con-Ratio: versely, a decrease in any current liability is a use of cash and is subtracted from the calculation. SGA: Subtract selling, general, and administrative expenses. Interest

> Add interest expense to the calculation if SGA "expense"

includes interest expense.

Excess (Deficit)

Cash Flow: Represents cash available before

debt service.

Calculation of Supplemental/Traditional Cash Flow

Net Income: Amount of net income reported on most recent annual income

statement before taxes.

Interest

Expense: Add the total amount of interest

expense for the period.

Depreciation/ Amortization:

Add all noncash depreciation

and principal amortization on

outstanding debt.

Indicates net Earnings Before

Interest, Taxes, Depreciation, and Amortization (EBITDA). Amortization should include both principal and interest pay-

ments required on debt.

Subtract scheduled principal

and interest payments.

Subtract all capital expendi-

tures for the period.

Total amount of excess or deficit cash flow for the period after

debt service.

Cash flow before debt service divided by debt service (princi-

pal and interest).

Importance of Financial Analysis

While cash-flow analysis is critical in reviewing whether a borrower has the ability to repay individual debt, a review of the borrower's other

Expense:

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financial statements can offer information about other sources of repayment, as well as the borrower's overall financial condition and future prospects. The availability of historical balancesheet and income information, which allow declining trends to be identified, is critical. Also, it may be appropriate to compare the borrower's financial ratios with the average for the industry overall. Much of the financial information that examiners will review will not be audited: therefore, considerable understanding of general accounting principals is necessary to competently review an unaudited financial statement. At a minimum, financial statements should be obtained annually; where appropriate, the branch also should obtain monthly or quarterly statements.

When reviewing a credit file of a borrowing customer of a branch, the following financial information should be available for review: income statement, balance sheet, reconciliation of equity, cash-flow statements, and applicable notes to financial statements. The components for a financial review can be segregated into three areas: operations management, asset management, and liability management. Operations management is derived from the income statement and can be used to assess company sales, cost control, and profitability. Asset management involves the analysis of the quality and liquidity of assets, as well as the asset mix. Liability management covers the analysis of the company's record of matching liabilities to the asset conversion cycle, such as long-term assets being funded by long-term liabilities.

In studying these forms of management, various ratios will help the examiner form an informed and educated conclusion about the quality of the credit being reviewed. The ratios can be divided into four main categories:

- Profitability ratios. These ratios measure management's efficiency in achieving a given level of sales revenue and profits, as well as management's ability to control expenses and generate return on investment. Examples of these ratios include gross margin, operating profit margin, net profit margin, profit-to-sales ratio, profit-to-total assets ratio, and direct cost and expense ratios.
- Efficiency ratios. These ratios, which measure management's ability to manage and control assets, include sales to assets, inventory days on hand, accounts receivable days on hand, accounts payable days on hand, sales to net

fixed assets, return on assets, and return on equity.

- Leverage ratios. These ratios compare the funds supplied by business owners with the financing supplied by creditors, and measure debt capacity and ability to meet obligations. These ratios may include debt-to-assets, debtto-net-worth, debt-to-tangible-net-worth, and interest coverage.
- Liquidity ratios. Include ratios such as the current ratio and quick ratio, which measure the borrower's ability to meet current obligations.

Common "Red Flags"

The symptoms listed below are included to provide an understanding of the common problems or weaknesses examiners encounter in their review of financial information. While one symptom may not justify criticizing a loan, when symptoms are considered in the aggregate, they may help the examiner detect near-term trouble. This list is only a sampling of "red flags" that should prompt further review; examiners should also be able to identify issues that may require further investigation from their cursory review of a borrower's financial statement.

- A slowdown in the receivables collection period. This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts.
- Noticeably rising inventory levels in both dollar amount and percentage of total assets. Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining. The increase in inventory levels or lower turnover ratios may also be related to the borrower's natural reluctance to liquidate excessive or obsolete goods at a reduced price. Many businesses are willing to sacrifice liquidity to maintain profit margins.
- Slowdown in inventory turnover. This symptom may indicate overbuying or some other imbalance in the company's purchasing policies, and it may indicate that inventory is slow-moving. If the inventory is undervalued, the actual turnover is even slower than the calculated results

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Existence of heavy liens on assets. Evidence
of second and third mortgage holders is a sign
of greater-than-average risk. The cost of junior
money is high. Most borrowers are reluctant
to use this source of funds unless conventional
sources are unavailable.

- Concentrations of noncurrent assets other than fixed assets. A company may put funds into affiliates or subsidiaries for which the branch may not have a ready source of information on operations.
- High levels of intangible assets. Intangible assets, which shrink or vanish much more quickly than hard assets, usually have very uncertain values in the marketplace. In some cases, however, intangible assets such as patents or trademarks have significant value and should be given considerable credit.
- Substantial increases in long-term debt. This symptom causes increasing dependence on cash flow and long-term profits to support debt repayment.
- A major gap between gross and net sales. This
 gap represents a rising level of returns and
 allowances, which could indicate lower quality or inferior product lines. Customer dissatisfaction can seriously affect future profitability.
- Rising cost percentages. These percentages can indicate the business's inability or unwillingness to pass higher costs to the customer or its inability to control overhead expenses.
- A rising level of total assets in relation to sales. If a company does more business, it will take more current assets in the form of inventory, receivables, and fixed assets. Examiners should be concerned when assets are increasing faster than sales growth.
- Significant changes in the balance-sheet structure. These changes may not be the customary changes mentioned previously, but they are represented by marked changes spread across many balance-sheet items and may not be consistent with changes in the marketplace, profits or sales, product lines, or the general nature of the business.

BANKRUPTCY LAW AND COMMERCIAL LOANS

This section provides examiners with an overview of the United States Bankruptcy Code (code) chapters that affect commercial and industrial loans. Bankruptcy law is a significant body

of law; it would be difficult in this manual to discuss all the issues necessary for comprehensive understanding of the code. This subsection will focus on basic issues that an examiner needs to be familiar with relative to three principal sections of the code, chapters 7, 11, and 13.

Creditors of a Bankrupt Business

A creditor in bankruptcy is anyone with a claim against a bankrupt business, even if a formal claim is not filed in the bankruptcy case. In bankruptcy court, a claim is defined very broadly. A claim may include a right to payment from a bankrupt business, a promise to perform work, or a right to a disputed payment from the debtor that is contingent on some other event. The two basic types of creditors are secured and unsecured. Secured creditors are those with perfected security interest in specific property, such as equipment, accounts receivable, or any other asset pledged as collateral on a loan. Unsecured creditors are generally trade creditors and others who have not taken a specific interest in property supplied to the bankrupt debtor.

Voluntary Versus Involuntary Bankruptcy

When a debtor files a bankruptcy petition, it is described as a voluntary bankruptcy filing. The individual or organization does not have to be insolvent to file a voluntary case. Creditors may also file a bankruptcy petition, in which case the proceeding is known as an involuntary bankruptcy. This form of petition can occur in chapters 7 and 11 bankruptcy cases, and the debtor generally must be insolvent. To be deemed insolvent, the debtor must be unable to pay debts as they mature. However, the code does limit who an involuntary action can be sought against.

Chapter 7—Liquidation Bankruptcy

A chapter 7 action may be filed by virtually any person or business organization that is eligible to file bankruptcy. Chapter 7 bankruptcy can be filed by a sole proprietorship, partnership, corporation, joint stock company, or any other

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business organization. Restrictions apply to only a few highly regulated businesses, such as railroads, insurance companies, banks, municipalities, and other financial institutions. This chapter is often referred to as "straight liquidation" or the orderly liquidation of all assets of the entity. Generally, a debtor in a chapter 7 bankruptcy case is released from obligations to pay all dischargeable pre-bankruptcy debts in exchange for surrendering all nonexempt assets to a bankruptcy trustee. The trustee liquidates all assets and distributes the net proceeds on a pro rata basis against the allowed claims of unsecured creditors. Secured creditor claims are generally satisfied by possession or sale of the debtor's assets. Depending on the circumstances, a secured creditor may receive the collateral, the proceeds from the sale of the collateral, or a reaffirmation of the debt from the debtor. The reaffirmed debts are generally secured by property that the debtor can exempt from the bankruptcy estate, such as a home or vehicle. The amount of the reaffirmation is limited to the value of the asset at the time of the bankruptcy filing.

Some characteristics of a chapter 7 bankruptcy are described below:

- A trustee is appointed in all chapter 7 bankruptcies and acts as an administrator of the bankruptcy estate. The bankruptcy estate that is established when the petition is filed becomes the legal owner of the property. The trustee acts to protect the interest of all parties affected by the bankruptcy.
- The trustee has control of all nonexempt assets of the bankrupt debtor.
- The trustee is required to liquidate the estate quickly without jeopardizing the interests of the affected parties.
- The proceeds from the sale pay trustee's fees and other creditors. Trustee fees are determined according to the amount disbursed to the creditors and are a priority claim.
- A chapter 7 bankruptcy is typically completed in 90 days, depending on the time needed to liquidate collateral. In rare situations, other chapter 7 bankruptcies may take years to complete.
- The court may allow the trustee to continue to operate a business, if this is consistent with the orderly liquidation of the estate.

Chapter 11—Reorganization

Most major or large businesses filing bankruptcy file a chapter 11 reorganization. As in chapter 7, virtually any business can file bankruptcy under chapter 11. There are specialized chapter 11 reorganization procedures for certain businesses such as railroads, and chapter 11 is not available to stockbrokers, commodity brokers, or a municipality. The basic concept behind chapter 11 is that a business gets temporary relief or a reprieve from paying all debts owed to creditors. This temporary relief gives the business time to reorganize, reschedule its debts (at least partially), and successfully emerge from bankruptcy as a viable business. The basic assumption underlying a chapter 11 bankruptcy is that the value of the enterprise as a going concern will usually exceed the liquidation value of its assets.

Reorganization Plan

Generally, the debtor has an exclusive 120-day period to prepare and file a reorganization plan. If the debtor's plan has not been confirmed within 180 days of the bankruptcy filing, a creditor may file a plan. A plan can provide for any treatment of creditor claims and equity interest, as long as it meets the requirements set out in the code. For example, a plan must designate substantially similar creditor claims and equity interest into classes and provide for equal treatment of such class members. A plan must also identify those classes with impaired claims and their proposed treatment. Finally, a method of implementation must be provided. Although plans do not have to be filed by a deadline, the bankruptcy judge will generally place a deadline on the debtor or creditor authorized to prepare the plan.

Some characteristics of a chapter 11 bankruptcy are described below.

- The bankrupt debtor usually controls the business during the bankruptcy proceedings. This arrangement is referred to as "debtor in possession."
- The business continues to operate while in bankruptcy.
- The debtor is charged with the duty of developing a reorganization plan within the first 120 days of the filing. After this period

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expires, the court may grant this authority to a creditors' committee.

- Once the plan is approved by the bankruptcy court, the debtor's payment of debts is generally limited to the schedule and amounts that are detailed in the reorganization plan.
- A chapter 11 proceeding can be complex and lengthy, depending on the number of creditors, amount of the debts, amount of the assets, and other factors that complicate the proceedings.

Chapter 13—Wage-Earner Bankruptcy

A chapter 13 bankruptcy is available to any individual whose income is sufficiently stable and regular to enable him or her to make payments under the plan. As long as the individual has regular wages or takes a regular draw from his or her business, the individual may qualify under chapter 13 of the code. Under chapter 13, an individual or married couple can pay their debts over time without selling their property. As a protection to creditors, the money paid to a creditor must equal or exceed the

amount that the creditor would get in a liquidation or chapter 7 bankruptcy. Chapter 13 may be used for a business bankruptcy, but only if the business is a proprietorship. In most cases, the business needs to be fairly small to qualify.

Some characteristics of a chapter 13 bankruptcy are described below:

- In most cases, only an individual can file a chapter 13 bankruptcy.
- Secured debt may not exceed \$350,000.
- Unsecured debt may not exceed \$100,000.
- The debtor must propose a good-faith plan to repay as many debts as possible from available income.
- A debtor makes regular payments to a trustee, who disburses the funds to creditors under the terms of the plan.
- The trustee does not control the debtor's assets.
- A chapter 13 bankruptcy may include the debts of a sole proprietorship. The business may continue to operate during the bankruptcy.
- After all payments are made under the plan, general discharge is granted.

Commercial Loans Examination Objectives

Effective date July 1997

Section 3050.2

- To determine if lending policies, practices, procedures, and internal controls regarding commercial loans are adequate.
- 2. To determine if branch officers are operating in conformance with the established guidelines.
- To evaluate the portfolio for credit quality, performance, collectibility, and collateral sufficiency.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Commercial Loans Examination Procedures

Effective date July 1997

Section 3050.3

Refer to the Credit Risk Management examination procedures for general procedures to assess the risk of commercial lending activities. However, if the branch conducts significant commercial lending activities, and additional information is needed, the examiner should perform the following procedures.

- If selected for implementation, complete or update the Internal Control Questionnaire for this area.
- Determine if deficiencies noted at previous examinations and internal/external audits have been addressed by management.
- 3. If the branch has any credits that should be reviewed under the Shared National Credit program but were omitted (other than new credits that originated since the previous review) submit a memorandum to the SNC coordinator detailing those credits to the respective Federal Reserve District. Do not include subparticipations, where the branch purchased its share from either a bank in the original syndicate, or from a bank considered a first-tier participant. Subparticipations should only be tracked internally by the branch.

Commercial Loans Internal Control Questionnaire

Effective date July 1997

Section 3050.4

Refer to the Credit Risk Management internal control questionnaire for a general review of the branch's internal controls, policies, practices, and procedures. If additional information is needed, complete the following internal control questionnaire. For audit procedures, refer to the Credit Risk Management section 3010.5.

POLICIES

- 1. Has the head office adopted written commercial loan policies for the branch that:
 - a. Establish procedures for reviewing commercial loan applications?
 - b. Define qualified borrowers?
 - c. Establish minimum standards for documentation?
- 2. Are policies reviewed, at least annually, to determine if they are compatible with changing market conditions?
- 3. Do loan records provide satisfactory audit trails that permit the tracing of transactions from initiation to final disposition?
- 4. Has the branch instituted a system that ensures:
 - a. Security agreements are filed?
 - b. Collateral mortgages are properly recorded?
 - c. Title searches and property appraisals are performed in connection with collateral mortgages?
 - d. Insurance coverage, including loss payee clause, is in effect on property covered by collateral mortgages?
 - e. The borrower is in compliance with all the covenants of the loan agreement?
- 5. Does the branch have an internal review system that:
 - a. Ensures liens are perfected?

- b. Checks collateral values when the loan is made and at reasonable intervals thereafter?
- c. Ensures that cash flow analyses are performed on appropriate borrowers in a timely manner?
- d. Determines that loan payments are promptly posted?
- 6. Do working capital loans require clean-up periods?
- 7. Who is responsible for monitoring the clean-up period, the account officer or an independent source?
- 8. What are the consequences if the borrower cannot clean-up the line?
- 9. Are different criteria used for loans to borrowers on an unsecured basis versus a secured basis (e.g. more stringent documentation requirements, more frequent credit reviews, or cashflow analyses)?
- 10. Is there any evidence that the branch is extending working capital loans to finance the acquisition of long-term assets or capital?
- 11. Do all term loans require meaningful principal amortization (at least quarterly)?
- 12. Does the term of the loan correspond to the useful life of the underlying asset being financed?

CONCLUSION

- 13. Is the information covered by this internal control questionnaire adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Effective date July 1997

Corporate restructurings have become a technique for financing acquisitions through leveraged buyouts, resisting takeovers, and restructuring corporate balance sheets. They encompass traditional leveraged buyouts, management buyouts, corporate mergers and acquisitions, and significant stock buybacks. Leveraged Employee Stock Option Plans (ESOPs) may also be considered as corporate restructurings if they are used to acquire or recapitalize an existing business.

It is not considered inappropriate for branches to lead and/or participate in loans to finance corporate restructurings so long as they are conducted in a sound and prudent manner. However, booking of such credits could affect asset quality and increase overall levels of risk exposure.

Corporate restructurings involve many of the same characteristics and risks that have traditionally been evaluated during on-site examinations. These relate to the borrower's income, cash flow, and general ability to pay interest and principal on outstanding debt; economic conditions and trends; the borrower's management; and the borrower's ability to realize value through the sale or liquidation of assets. What usually distinguishes corporate restructurings from typical bank loans is the level of debt the borrower assumes in relation to standard measures of financial capacity or ability to repay. Clearly, a high level of debt in relation to net worth or total assets can place heavy demands on a borrower's cash flow and reduce the borrower's ability to absorb the effects of unanticipated financial shocks or economic adversity.

Branches may be involved in corporate restructurings at a number of levels. First, they, together with other institutional lenders, may provide senior secured financing that typically represents the largest portion of a corporate restructuring. In addition, branches may extend credit on a subordinated basis. Bridge loans also represent another type of financing, which may be considered as senior debt or mezzanine financing, depending on its characteristics.

Because corporate restructurings traditionally entail high leverage, they often increase the vulnerability of borrowers to adverse market and financial developments and have the potential to raise the level of risk in bank loan portfolios. For these reasons, bank supervisors have actively urged bank management to exer-

cise caution and apply especially rigorous lending and investing standards in participating in these transactions.

WAYS TO FINANCE CORPORATE RESTRUCTURINGS

Corporate restructurings are typically financed through a complex combination of debt and equity instruments. A general overview of the types of financings is provided as follows:

Senior Debt

This term refers to all loans and debt securities secured by first liens on assets or the stock of the borrower's operating entities; and, any unsecured loans and debt securities, which have priority in repayment over all other creditors and equity investors in the event of liquidation. The majority of senior debt generally consists of secured term loans; however, other types of debt, including revolving working capital loans, bridge loans, and debt securities may be considered senior debt. To be considered as senior debt, the loans must not be subordinated to any other obligations in the event of liquidation.

Mezzanine Financing

Mezzanine financing consists of all layers of financing between senior debt and equity investments. These include all unsecured loans and debt securities where payment is subordinated, loans or debt securities secured by liens inferior to those of senior debt, fully subordinated debt, and any limited-life preferred stock with significant debt characteristics.

Bridge Loans

Bridge loans have varying characteristics and are considered as either senior debt or mezzanine financing based upon the definitions above. Repayment of bridge loans is dependent on the successful marketing of longer term securities or the sale of assets for repayment. Bridge loans that would be subordinated to other obligations

in the event of liquidation are considered mezzanine financing.

Noninvestment Grade Bonds

These bonds consist of all noninvestment-grade, high-yield debt securities involved in corporate restructurings (commonly referred to as junk bonds). This includes various types of high yield issues, which have attributes of debt, such as zero-coupon or zero-slash bonds and pay-inkind (PIK) bonds. Pay-in-kind preferred stock and other issues with significant equity attributes are considered equity investments.

Financing Corporate Restructurings Examination Objectives

Effective date July 1997

Section 3060.2

- To determine if policies, practices, procedures, and internal controls regarding corporate restructurings are adequate.
- To determine if branch officers are operating in conformance with the established guidelines.
- 3. To determine compliance with applicable laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Financing Corporate Restructurings Examination Procedures

Effective date July 1997

Section 3060.3

Determine if management performs the following:

- Evaluates the adequacy and stability of the borrower's current and prospective cash flow under varying economic scenarios, including the possibility of an economic decline.
- Sets reasonable in-house limits regarding exposure to individual borrowers, total exposure to all corporate restructured borrowers, and industry concentrations resulting from corporate restructurings.
- Establishes credit analysis, approval, and review procedures that take account of the high levels of debt involved in these transactions.
- 4. Maintains internal systems, controls, and reporting procedures that track the performance and condition of individual exposures, monitor the organization's compliance with internal procedures and limits and keep head office management adequately informed on a timely basis of the organization's involvement in corporate restructurings.
- 5. Establishes pricing policies and practices that take into account a prudent manner of the trade-off between risk and return.
- Avoids compromising sound banking practices in an effort to broaden market share or realize substantial fees.

Effective date July 1997

This section refers to deposit accounts with nonrelated banking organizations. These deposit accounts can be either noninterest-bearing settlement accounts (demand) or interest-bearing deposits and placements (time). For information on accounts with *related* banking offices and affiliates see the Due From/Due To Related Offices section of this manual. In addition, the instructions for the FFIEC 002, Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, are an important source of information on accounts with nonrelated and related offices and institutions.

DEMAND DEPOSITS

Banks maintain deposits in other banks to facilitate the transfer of funds. Those assets, known as due from banks-demand, correspondent bank balances, or settlement accounts, are a part of the primary, uninvested funds of every bank. A transfer of funds between banks may result, in part, from the collection of cash items, the transfer and settlement of securities transactions, the transfer of participating loan funds, and the purchase or sale of Federal funds.

Banks also utilize other banks to provide certain services that can be performed more economically or efficiently by the other banks because of their size or geographic location. Such services include processing of cash letters, packaging loan agreements, funding overline loan requests of customers, performing EDP services, collecting out-of-area items, exchanging foreign currency, and providing financial advice in specialized loan areas. When the service is one-way, the bank receiving that service usually maintains a minimum balance that acts as a compensating balance in full or partial payment for the services received.

Some banks, particularly branches, must be prepared to make and receive payments in foreign currencies to meet the needs of their international customers. This can be accomplished by maintaining foreign currency due from banks-demand accounts with affiliates (nostro balances) or with other banks in foreign countries.

TIME DEPOSITS

Branches also maintain interest-bearing time deposits, known as due from banks-time, with other banks. Those assets may also be referred to as placements, placings, interbank placements (deposits), redeposits or even Federal funds, in instances where their maturities are similar to Federal funds. These placements represent a source of primary liquidity to many branches.

All banks with which the branch has demand and time accounts shown on its books should be subject to an appropriate level of scrutiny for creditworthiness, which should be documented in the branch's on-site credit files. In cases, where these credit evaluations are conducted by the head office or another related office, branch management should obtain copies of these evaluations for its files.

Due from banks-time deposit activities became important with the growth of the Eurodollar market. The bulk of due from banks-time deposits now consist of Eurodollars, with smaller amounts in other Eurocurrencies. Other foreign currency time deposits are placed in substantially the same manner as Eurodollar deposits, subject to differing exchange control regulations or local customs.

Eurodollar (interbank) deposits are sometimes linked with foreign exchange transactions. As a result, the branch's foreign exchange or Eurocurrency deposit traders frequently work closely with the trader responsible for placing due from banks-time deposits. Foreign exchange brokers also may act as intermediaries if warranted by market conditions, local customers, the size of the branch, or other factors.

The practice of placing interbank deposits (and takings on the liability side) originated in London because, under U.K. regulations, banks were entitled to "accept" interbank deposits whereas interbank borrowings (i.e. loans) required authorization by the Bank of England. Therefore, due from banks-time deposits are "accepted" even though the receiving bank may have instructed its foreign exchange trader, directly or through brokers, to find a bank willing to offer it such deposits.

Due from banks-time deposits contain the same credit and country risks as any extension of credit to a bank. Consequently, a prudently managed bank should place deposits with (i.e. lend to) only well-managed banks. The traders

should be provided with a list of approved banks with which funds can be deposited up to prescribed limits for each bank. Due from banktime deposits differ from other types of credit extensions because they often represent deposits of relatively short maturity which normally receive first priority in case of insolvency. Nevertheless, the credit and country exposure exists, and customer limits must be established by credit officers and not by foreign exchange traders. Such limits must be reviewed regularly by credit officers, particularly during periods of money market uncertainty or rapidly changing economic and political conditions.

The examiner also must recognize that credit risks intensify when due from bank-time deposits are placed for longer periods. Furthermore, the credit risks for specialized or smaller banks that have recently entered the interbank deposit market can be far greater than that for larger, long-established banks. Banks which traditionally utilized only regular lines of credit or special facilities also have entered the due from banks-time deposit market to meet their external needs. Those banks could be the first to be caught in a market crunch.

Incoming confirmations from banks must be meticulously checked by the bank to record copies in each instances to protect against fraud and errors. Similarly, a systematic follow-up on non-receipt of incoming confirmations should be carefully monitored by the bank.

Due From Nonrelated Banks Examination Objectives

Effective date July 1997

Section 3070.2

- To determine if the policies, practices, procedures, and internal controls regarding balances due from banks, both demand and time, are adequate.
- To determine if branch officers and employees are operating in conformance with established guidelines.
- To determine that all due from accounts are reasonably stated and represent funds on deposit with other banks.
- To determine whether the branch evaluates the credit quality of banks with which demand and time accounts are maintained.
- To determine the scope and adequacy of the internal and external audit coverage as it applies to this area.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

Due From Nonrelated Banks Examination Procedures

Effective date July 1997

Section 3070.3

- If included in the scope of the examination, complete or update the Internal Control Ouestionnaire.
- Test for compliance with policies, practices, procedures, and internal controls within the parameters of the established scope.
- Scan the most recent bank-prepared reconcilements for any unusual items and determine that closing balances listed on reconcilements agree with the general ledger and with the balance shown on the cut-off statement if one has been obtained.
- If the bank's policy for charge-off of old open items provides for exceptions in extenuating circumstances, review excepted items and determine if charge-off is appropriate.
- 5. If the bank has no policy for charge-off of old open items, review any items which are large or unusual or which have been outstanding for over two months, along with related correspondence, and determine if charge-off is appropriate.
- Obtain a trial balance of the due from banks
 —time balances. Reconcile balances to
 department controls and general ledger.
- Check a sample of confirmations. This will ensure that the balances are indeed due from bank balances and not loans to banks (for Call Report purposes). If any transactions

- are not confirmed as of the date of examination, determine why incoming confirmation is missing.
- 8. The credit quality of placements is included in the scope of the asset quality review. Using appropriate sampling techniques, select deposit customers for examination and review the credit file maintained on each bank. Ensure the bank has performed a credit analysis on all approved due from bank counterparties. If the credit analysis has been prepared by the head office, shadow files need to be maintained at the institution.
- Check back office procedures, adequacy of separation of duties, and who monitors limits.
- 10. If problems are detected concerning the institution's policies or lack thereof, the deficiencies should be discussed under Risk Management. If the institution is deficient in its operations and is not following its policies, the exception should be discussed under Operational Controls.
- Prepare comments on deficiencies or violations of law noted above for inclusion in the examination report.
- 12. Assemble workpapers to support conclusions reached. Include any information that will facilitate future examinations.

Due From Nonrelated Banks Internal Control Questionnaire

Effective date July 1997

Section 3070.4

AUDIT COVERAGE

- 1. Does the scope of the branch's internal audit program include procedures covering:
 - a. Due from banks-demand accounts?
 - b. Due from banks-time accounts?
- Do audit procedures include all of the following to ascertain the effectiveness of internal controls:
 - Ensure that procedural manuals or instructions covering the reconcilement function exist?
 - b. Ascertain if statements are not reconciled by an individual, who also:
 - Has signing authority on the account?
 - · Approves entries?
 - · Posts the general ledger?
 - Effects money transfers?
 - c. Ensure that statements are reconciled promptly when received?
 - d. Check to see that reconcilements are prepared on preprinted forms?
 - e. Ensure that completed reconcilements are properly stored to satisfy recordretention requirements?
 - f. Ensure that open items are promptly referred to and followed up by the appropriate operating department or responsible officer?
 - g. Test that open entries outstanding beyond a reasonable length of time are:
 - Referred to appropriate senior branch management in writing?
 - Charged off to profit/loss accounts?
 - Transferred to special suspense accounts, pending additional follow-up action?
 - h. Ensure that reconciliation personnel are prohibited from preparing adjusting entries?
 - i. Spot check selected general ledger tickets and supporting documentation for:
 - Adequate details of the transaction?
 - Proper officer approvals?
 - j. Test check on selected transactions that include open, reconciled, adjusted, and charged-off items to ascertain propriety of disposition?

POLICIES FOR DUE FROM BANKS

- Do current written policies and procedures exist for due from banks-demand accounts that:
 - a. Provide for periodic review and approval of balances maintained in each such account?
 - b. Indicate person(s) responsible for monitoring balances and the application of approved procedures?
 - c. Establish levels of check-signing authority?
 - d. Indicate officers responsible for approval of transfers between correspondent banks and procedures for documenting such approval?
 - e. Indicate the supervisor responsible for regular review of reconciliations and reconciling items?
 - f. Indicate that all entries to the accounts are to be approved by an officer or appropriate supervisor and that such approval will be documented?
 - g. Establish time guidelines for charge off of old open items?
- Do current written policies and procedures exist for due from banks-time account that:
 - a. Establish maximum limits of the aggregate amount of due from banks-time deposits for each:
 - Bank?
 - Currency of deposit?
 - Country of deposit?
 - b. Restrict due from banks-time deposits to only those customers for whom lines have been established?
 - c. Establish definite procedures for:
 - Balancing of accounts?
 - · Holdover deals?
 - Rendering of reports to management, external auditors, and regulating agencies?
 - · Accounting cut-off deadlines?
 - Handling of interest?
- 5. Are the policies and procedures for due from bank accounts reviewed at least annually to determine their adequacy in light of changing conditions?

BANK RECONCILEMENTS

- 6. Are branch reconcilements prepared promptly upon receipt of the statements?
- 7. Are statements examined for any sign of alteration and are payments or paid drafts compared with such statements by the persons who prepare branch reconcilements? If yes, skip question 8.
- 8. If the answer to question 7 is no, are statements and paid drafts or payments handled before reconcilement only by persons who do not also:
 - a. Issue drafts or official checks and prepare, add, or post the general or subsidiary ledgers?
 - b. Handle cash and prepare, add, or post the general ledger or subsidiary ledgers?
- 9. Are branch reconcilements prepared by persons who do not also:
 - a. Issue drafts or official checks?
 - b. Handle cash?
 - c. Prepare general ledger entries?

- 11. Are overdrafts in due from bank accounts properly recorded on the branch's records and promptly reported to the responsible officer?
- 12. Are individual interest computations checked or adequately tested by persons independent of those functions?
- 13. Are accrual balances for due from bankstime verified periodically by an authorized official? If so, indicate frequency.
- 14. Do all internal entries require the approval of appropriate officials?

CONCLUSION

- 15. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e., strong, satisfactory, fair, marginal, unsatisfactory).

OTHER

10. Is a separate general ledger account or individual subsidiary account maintained for each due from bank account?

Due From Nonrelated Banks Audit Guidelines

Effective date July 1997

Section 3070.5

- Determine the number of the last unissued draft of each due from bank account and record for comparison when performing reconcilements.
- Prepare a listing of all due from bank accounts, together with their balances from the branch's daily statement as of the examination date. Compare each balance or total balances to the appropriate subtotal in the general ledger as of the examination date.
- Request a cut-off statement as of the examination date and for a subsequent date, not less than five days later for each due from account. Include instructions that the statements be addressed to the examiner-incharge and be delivered unopened.
- 4. In preparing or reviewing reconcilements:
 - a. Review reconciling items carefully to determine that the time period between debit or credit entries and the offsetting credit or debit by the correspondent bank is comparable for similar types of items. If any differences in timing occur, ascertain the reason.
 - b. Determine that wire transfers appear on the correspondent statement the same day as entered on the branch's books. Determine the reason for any exception.
 - c. Test all drafts included in the cut-off statement for authorized signature, proper endorsement, dates of drafts, payee, and amounts and determine that:
 - Dates drawn are not subsequent to dates paid by the correspondent bank.
 - Drafts issued to transfer funds from the branch's account to the correspondent's account are not outstanding more than the normal transit time.
 - · Drafts are numbered.
 - Drafts are issued sequentially.
- Reconcile due from bank accounts on a reconcilement form using the following steps:
 - a. Prove the mathematical accuracy of the prior reconcilement by a machine run of the figures.
 - Determine that our balance to their debit agrees to general ledger as of their prior reconcilement date.
 - Determine that their balance to our credit agrees to each correspondent bank statement as of the prior reconcilement date.

- d. Determine that the closing balance and date listed on the statement used in the branch's last reconcilement agrees to the opening balance and date listed on the cut-off statement as of the examination date.
- Determine that any open items from previous reconcilements have cleared.
- f. If any items on a previous reconcilement do not clear, list on the reconcilement form being prepared.
- g. Determine that each debit and credit entry shown on the general ledger since the date of the last reconcilement is offset by a corresponding credit or debit on the correspondent bank's cut-off statement.
- h. Any items on the general ledger, except outstanding drafts, that are not offset by an appropriate debit or credit on the correspondent bank's cut-off statement are considered open and should be transferred to the reconcilement form under the appropriate we debit or we credit caption along with the date and a brief description.
- i. Any items on the correspondent bank's cut-off statement that are not offset by an appropriate debit or credit on the branch general ledger are considered open and should be transferred to the reconcilement form under the appropriate they debit or they credit caption along with the date and a brief description.
- j. "We credit" items that represent drafts outstanding should not be listed on the "we credit" section of the reconcilement form. Each outstanding draft should be listed by number on the reverse side of the reconcilement form and the total should be carried forward opposite the caption drafts outstanding. The listing should include any drafts still outstanding from the previous reconcilement.
- k. Prove the reconcilement.
- Determine clearance of "we debit" and "we credit" items using later cut-off statements, when available, and:
 - a. If an item is cleared by reversing the entry, that is, by a subsequent offsetting debit or credit entry on the ledger of the branch under examination, check the entry through to its source.

- b. All material "we debit" and "we credit" items that do not clear on the later cut-off statements received should be confirmed. with a copy of the confirmation tracer retained for comparison to the original after it is returned.
- 7. Utilizing the general ledger or appropriate subsidiary ledger, determine clearance of "they debit" and "they credit" items. The reason for nonclearance should be determined for all "they debit" and "they credit" items that do not clear in a reasonable amount of time.
- 8. Review the accrued interest accounts by:

- a. Reviewing and testing procedures for accounting for accrued interest and for handling adjustments.
- b. Scanning accrued interest for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.
- 9. Obtain or prepare a schedule showing the accrued interest balances and the deposit balances for selected time periods since the previous examination.
 - a. Calculate ratios.
 - b. Investigate significant fluctuations and/or

Section 3080.1

Effective date July 1997

Financing foreign receivables includes open account financing, sales on consignment, advances against collections, banker's acceptances, factoring, and forfaiting. Certain foreign receivables are guaranteed or insured for credit and political risk by the Export-Import Bank of the United States, the Foreign Credit Insurance Association, or other American and foreign organizations.

OPEN ACCOUNT FINANCING

The simplest method of financing foreign receivables is on open account. In such a sale, the buyer and seller agree on payment at a specified date without any negotiable instruments, such as a draft or acceptance, evidencing the obligation. In most instances, the shipping documents are sent directly to the buyer rather than through a bank. The exporter may request the buyer to make payment to the bank in which the exporter maintains an account. The advantages of an open account sale are its simplicity and the lack of bank charges and stamp duties applied to drafts by certain countries.

The financing of open account sales contains certain risks. The lending bank and exporter have no control over the documents and the buyer (importer) may take possession of the goods without the bank's or the exporter's consent. In addition, if the importer does not register the goods with the proper authorities, the dollar or other exchange may not be available at the time of payment. Probably the greatest risk in open account financing is the lack of standard trade financing documentation on which to base legal action against the importer in the event of default. Therefore, open account sales are most appropriate when the buyer (importer) is a subsidiary of a related company or is well-known to the seller.

SALES ON CONSIGNMENT

Under a consignment arrangement, goods are consigned to the importer (consignee) abroad and the exporter (consignor) retains title to them until they are sold to a third party. However, unless the shipment is made to an exporter's overseas branch or subsidiary, the credit risk is

considerable. As with open account sales, there is a lack of standard trade financing documentation on which to base legal action if the consignee defaults. The exporter should thoroughly understand the inherent credit risks, especially when goods are consigned to an agent, representative, or import house abroad.

In countries with free ports or free trade zones, consigned goods may be placed in a bonded warehouse in the name of a foreign bank or branch of the bank. Arrangements may then be made to release the consigned merchandise at the time it is sold. Merchandise is cleared through customs after the sale has been completed. However, that type of consignment should not be made and will not usually be accepted by many foreign banks until all pertinent conditions, regulations, and storage facilities are verified. The exporter's bank also should verify that goods not sold may be returned to the country of origin. Bank financed consignment shipments should be limited to those countries that do not have burdensome foreign exchange restrictions and have sufficient foreign exchange available to pay for imports.

To overcome the disadvantages of financing shipments on an open account or consignment basis, exporters frequently ship goods against documentary collections. That practice means that the exporter, in the case of a time or arrival draft, and the exporter and the importer, jointly, in the case of a sight draft, finance(s) the shipment. The exporter and the importer may have unused credit lines with their banks and be able to borrow the needed money without tying the financing to the trade transaction. Often, however, the exporter's or the importer's regular bank lines are used up for other transactions. Consequently, they may ask their bankers to provide financing through advances against outward collections, discounting trade acceptances, bankers' acceptances, factoring, or forfaiting.

ADVANCES AGAINST FOREIGN COLLECTIONS

A manufacturer or merchant conducting a strictly domestic business often gets a loan from a bank, finance company, factor, or forfaiter by using accounts receivable as security. Because outward collections are the same as foreign receivables, the same general type of financing vehicle is available to exporters.

A common method of financing foreign receivables is for the exporter to pledge all outward collections to its bank. The exporter may then borrow from the bank up to a stated maximum percentage of the total amount of receivables pledged at any one time. When notes, rather than drafts, are used to finance foreign collections, they are usually paid on demand enabling the exporter to increase or decrease the loan depending on need and the current amount of collections outstanding. Preferably, all of the collections lodged with the exporter's bank should be pledged to the bank. When a particular collection is paid, it is remitted by the foreign collecting bank to the domestic bank that has advanced the funds. The latter uses the proceeds of the collection to reduce the exporter's loan. Some exporters have no need for a continuous financing arrangement but occasionally may wish to obtain financing on only one large foreign collection. In such instances, the branch may be willing to advance money with only that one receivable as security. Again, the branch establishes a maximum percentage of the amount of the draft that it is willing to advance. When payment for the receivable is obtained, the branch uses the proceeds to liquidate the loan, crediting any excess to the exporter. Bank financing in the form of advances against export collections is an accepted practice in international trade and is not considered factoring.

Besides having a pledge on the exporter's outward collections, the branch usually retains recourse to the exporter whose financial condition and reputation are of prime importance. Other factors, however, are also significant. If the foreign importers are prime companies with undoubted reputation and financial strength, the branch will probably advance a larger percentage on collections directed to them. The branch will also advance a larger percentage of funds to importers in those countries that promptly pay drafts drawn on them. In other countries, where payment is generally slow, perhaps because importers are financially weak or because U.S. dollar or other foreign currency exchange is hard to obtain, the branch will advance a lower percentage on collections. Certain collections to habitually slow paying importers or countries may be entirely ineligible for financing.

When a branch advances against foreign collections, it must carefully scrutinize the support-

ing documents. Because the branch wishes to maintain control of the merchandise, the bill of lading should be either to the order of the shipper and blank endorsed or to the order of the branch. The bill of lading must not be consigned to the buyer (importer); otherwise, the buyer has control over the goods. In addition, shipments financed should be covered by adequate insurance.

DISCOUNTING TRADE ACCEPTANCES

A draft accepted by the foreign buyer becomes a trade acceptance, carrying the full credit obligation of the importer. Such trade acceptances are also frequently called trade bills or trade paper. The acceptance is returned to, and becomes the property of, the exporter, who will ask the collecting bank to present it to the acceptor for payment at maturity. The exporter is, therefore, providing the financing or carrying its own foreign receivables. However, if the exporter needs the funds before maturity of the trade acceptance, the exporter may ask the branch to discount the draft with or without recourse. If the primary obligor (acceptor) is a well-known company of good credit standing, the branch may be willing to discount the draft without recourse to the exporter. More commonly, however, the lending bank looks to the exporter for recourse, should the primary obligor fail to pay the amount when due.

When discounting a trade acceptance, the branch advances the face amount of the draft to the exporter, minus discount charges, until the maturity date. In that case, the branch is buying the trade acceptance for value and is entitled to any benefits due it from the primary obligor as a holder in due course of a negotiable instrument. That is also the case whenever the branch makes advances against a single collection or a pool of collections. Any intermediary collecting bank also has a financial interest in the collection and has all the rights of a holder in due course under the Uniform Commercial Code.

BANKER'S ACCEPTANCES CREATED AGAINST FOREIGN COLLECTIONS

During periods of tight money, branches may choose to finance foreign collections by using banker's acceptances. Banker's acceptances are discussed separately in this manual, so the following comments relate only to the financing of foreign collections.

As with all acceptance financing, the exporter first submits a signed acceptance agreement to its bank. To obtain acceptance financing for foreign receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (importer) that, along with the necessary documents, is sent for collection in the usual manner. The other draft, for the same or smaller amount as agreed on by the branch and exporter, is drawn by the latter on the branch and has the same tenor as the draft drawn on the importer. The branch accepts the latter draft and discounts it, crediting the net amount to the exporter's account. The branch has now created a banker's acceptance that can be sold in the highly liquid acceptance market, provided the branch's reputation is fully established. When payment is received from the importer, the branch applies the proceeds to pay its own acceptance, which will be presented for payment if sold in the market. Should the importer default, the branch has recourse on the drawer and can demand payment from that source.

FACTORING

A factor buys accounts receivable with or without recourse. In the past, factoring was used primarily in domestic trade in certain industries, such as textiles. In recent years, however, several domestic factors have established foreign affiliates or invested in foreign finance companies and several banks have purchased or established factoring firms to finance foreign trade. Branches are also financing foreign trade by factoring.

Factoring is the purchase, on a without recourse basis, of the accounts receivable of a client. Factoring differs from asset-based lending financing, in that the factor assumes the credit and collection risk associated with the receivables. In asset-based lending these risks remain with the client. Among the principal advantages of factoring to the client, is that the client is certain of the collection of the proceeds of its sales, regardless of whether or not the factor is paid. Other advantages of factoring are that the client does not have to maintain a credit department to evaluate the creditworthiness of customers and collect past due accounts or

maintain bookkeeping or accounting records pertaining to the status of receivables. These responsibilities have been assumed by the factor. In addition, under the terms of an advance factoring arrangement, the client receives payment for its receivables before the time agreed upon under the normal terms of the invoice.

Maturity factoring and advance factoring are two basic types of service offered by the industry. In maturity factoring, an average maturity due date is computed for the receivables purchased during a period and the client receives payment on that date. Advance factoring uses the same computations; however, the client has the option of taking advance payments equal to a percentage of the balance due at any time prior to the computed average maturity due date. The unadvanced balance, sometimes called the client's equity, is payable on demand at the due date.

The typical factoring agreement stipulates that all accounts receivable of a client are assigned to the factor but not all are purchased without recourse. The agreement between the factor and the client will usually state that receivables subject to shipping disputes, errors, returns, and adjustments are chargeable back to the client because they do not represent bona fide sales. In addition, sales made by the client without the factor's approval are considered client risk receivables, with full recourse to the client if the customer fails to pay. The usual approval process requires the client to contact the factor's credit department before filling a sales order on credit terms. The credit department will conduct a credit review, determine the creditworthiness of the customer and approve or reject the sale. If the credit department rejects the sale, the client may complete the sale but at the client's own risk. The most commonly rejected sales are those to affiliates, to known bad risks, to customers whose credit cannot be verified, and to those customers whose outstanding payables exceed the factor's credit line to those customers.

Once a sale has been made and the receivable, whether or not approved, is assigned to the factor, the client's account will be credited for the net invoice amount of the sale. Trade or volume discounts, early payment terms, and other adjustments are deducted from the invoice amount. The receivable then becomes part of the client's availability to be paid in advance or at the computed date, depending upon the basis of the factoring arrangement.

Factoring Foreign Receivables

A factor who purchases a foreign receivable must approve the credit standing of a specified foreign obligor before the sales contract is concluded. If the foreign buyer's credit is not approved, the exporter may still make the shipment but at its own risk. If shipments to approved importers are made on a documentary collection basis, the drafts and documents are submitted to the factor who purchases them without recourse. The factor pays the money to the exporter either at the average maturity date, when actually received or, if financing is also required, immediately. Thereafter, the drafts and documents are routed through commercial banks for collection. Because the factor owns the drafts and documents, the collection process is undertaken for its account. Occasionally, a factor will make use of its own credit line with a commercial bank to carry receivables purchased from the exporter until payment is received from the ultimate buyer.

When financing imports, the factor may arrange for the opening of a letter of credit through its bank in favor of an overseas supplier. The factor becomes an intermediary between its customer and the bank, substituting its own credit for that of the client. Because the factor is guaranteeing the letter of credit, the bank is willing to open the credit, which it might not have done for the importer directly.

When the goods are shipped, the title documents are either consigned or endorsed over to the factor. The factor, in turn, releases the documents to the importer against either a trust receipt or warehouse receipt. All proceeds from subsequent sales are turned over to the factor. Once the final sale has been made to a customer approved by the factor, an account receivable is created. The factor, according to its agreement with the customer, buys that receivable without recourse.

When the bank turns over the shipping documents to the factor, arrangements must be made to pay under the sight letter of credit. The factor may pay the bank from its own funds. The goods are cleared through customs and the factor is paid on the average or final maturity date of the accounts receivable, which the factor has bought from its customer without recourse.

Time letters of credit are paid to the bank by the factor at maturity and the resulting acceptances are charged to the customer's account for payment to the factor when due.

Frequently, instead of making immediate payment under a sight letter of credit, the factor will utilize its credit line with the bank. This option may be taken by either asking the bank to create a banker's acceptance or by charging the factor's loan account. In both instances, the factor must pay the bank at maturity of the acceptance or loan. Such maturities should coincide as closely as possible with the expected payment of the accounts receivable by the ultimate customer.

A factor buying foreign accounts receivables created through open account shipments follows the same basic procedures as in purchasing domestic receivables. As discussed heretofore, the exporter and financing institution could lose control over the goods because the shipping documents are consigned directly to the importer. Consequently, open account shipments should be conducted only with prime foreign buyers.

Client Records

A client's balance sheet will have a due from factor account instead of accounts receivable. The account balance may be somewhat lower than a normal receivables balance, thus affecting turnover ratios and other short-term ratios. The difference relates to the client's ability to convert sales to cash faster with a factor than if the receivables were to be collected by the client.

Each month, the client receives an accounts current statement from the factor, detailing transactions on a daily basis. This statement reflects the daily assignments of receivables, remittances made (including overadvances and amounts advanced at the client's risk), deductions for term loans, interest charges, and factoring commissions. Credit memos, client risk charge-backs, and other adjustments also will be shown. Client risk charge-backs are the amounts deducted from the balance due to the client upon the failure of customers to pay receivables factored at client risk. The accounts current statement and the availability sheets are necessary for asset analysis. The accounting system that develops this data probably will be automated, allowing the factor to compare and monitor data on the client. Examiners should use the data provided, within client records, toenhance the asset analysis process for these types of credits.

Factor Records

The factor's balance sheet reflects the purchased accounts receivable as factored receivables on the asset side and due to clients as the corresponding liability. Usually, the due to clients balance will be less than the factored receivables balance because of payments and advances to the clients. If, however, the factor makes advances to the client for greater amounts than are due to the client, these amounts will be reflected on the asset side of the balance sheet as overadvances. Overadvances are tantamount to unsecured loans. A limit on the amount of overadvances available at any one time to the client should be included in the factoring agreement. Such limitation is generally based upon, but not necessarily secured by, the amount of the client's inventory. This relationship is used because, theoretically, the inventory will be sold to generate receivables that the factor has contracted to purchase. The proceeds from the factored receivables will then be used to repay the overadvance. The factor's income statement will show factoring commissions that represent the discount on the receivables purchased as income. Interest income for advances on the due to client balances may or may not be a separate line item.

An analysis of the changes in the relative proportions of the due to clients account should provide valuable input into the analysis of the earnings of a branch's factoring operation. Because factoring is a highly competitive industry, price cutting has reduced factoring commissions to a point where they provide minimal support to earnings; therefore, the interest margins on factoring advances have a significant impact on net income. The implication of the analysis of proportional changes is that as more clients take advances (reducing due to clients), profit margins should widen. Conversely, as the due to clients proportion of total liabilities rises, profit margins may be expected to narrow.

Evaluating the Factoring Operation

The evaluation of a branch's factoring operation includes: (a) a review of its systems and controls, and (b) an analysis of the quality of its assets. A major portion of a factor's assets will be factored receivables, for which the credit department has the responsibility for credit qual-

ity and collection. The other major portion of the assets will be the client loans and credit accommodations, such as overadvances and amounts advanced at the client's risk, for which the account officers are responsible.

Any factor's ability to buy receivables without recourse is predicated on its ability to make sound credit judgments regarding buyers. The factor, therefore, replaces the credit and, in part, the receivables bookkeeping departments of sellers. The credit department maintains a credit file for each of its client's customers, which are continually updated as purchases are made and paid for by the customers. These files include financial statements, credit bureau reports, and details of purchasing volume and paying habits. Credit information on domestic buyers is easier to obtain than on buyers located overseas. However, by establishing foreign affiliates, factors have improved their ability to determine the credit standing of foreign importers.

Systems and Controls

Considering the large volume of daily transactions that flows through a factor, any internal control that can be easily negated represents a potential problem. The review of the factoring department's internal systems and controls should be continuous during the examination. This review should include the credit controls for both clients and customers. Credit controls and systems must be responsive to the identification of these problems because problems can develop rapidly in factoring. Earnings are evaluated in terms of the department's own performance. The factoring department's earnings trends may be evaluated by using a comparative yield on assets approach. By analyzing yields on asset categories from period to period, the examiner will be able to make a judgment as to the efficiency of the systems. Factors are subject to the same price competition in the commercial finance market as accounts receivable financiers. Declining portfolio yields may reflect the inroads made by competition and may indicate a decline in future profitability.

Asset Evaluation

The asset evaluation involves an evaluation of (1) credit accommodations to each client and

(2) customer receivables purchased by the factor at its own risk. For the first part of the evaluation, generate a list of each client's aggregate credit exposure to the factor, both direct and indirect, including overadvances and receivables purchased at the client's risk. For the second part of the evaluation, use the aging schedule of factored receivables aggregated by customer but net of client risk receivables. Select clients and customers for review based upon the same selection methods used for the commercial loan review. Clients with high dilution of receivables (i.e., customer nonpayment due to returns, shipping disputes, and errors and the like) and those with client risk receivables equal to 20 percent or more of factored volume may also be included.

Credit Accommodations to Each Client

In order to evaluate credit accommodations to each client, generate a list of each client's aggregate credit exposure to the factor, both direct and indirect, including overadvances and receivables purchased at the client's risk. Although past due status is an essential element in evaluating customer accounts, it should be noted that for its clients, a factor usually collects principal and interest payments directly from the client's availability. This practice means that the expected delinquency rate is minimal. Past due volume is not an effective measure of client quality.

A client's availability is the sum of all factored receivables, less trade and other discounts, factoring commissions, client risk charge-backs, and other miscellaneous charges to the client's account. There may also be other deductions for letters of credit and other credit accommodations. An advance client's availability would be further reduced by advances on the factored receivables, interest charges, and the reciprocal of the contractually agreed upon advance percentage. This reciprocal, 20 percent in the case of an 80 percent advance client, is sometimes referred to as the client's equity in the factored receivables. Availability may be increased by liens on additional collateral, such as inventory, machinery and equipment, real estate, and other marketable assets. Loans against this type of collateral may be handled in the commercial finance section of a factoring department.

An analysis of the client's balance sheet should incorporate an assessment of the client's ability to absorb normal dilution and the potential losses associated with client risk receivables, particularly when these elements are higher than usual for the portfolio. The analysis also should consider the client's ability to repay any advances received from the factor in the form of overadvances, term loans, or other credit accommodations.

When classifying the credit exposure to a client, the client risk receivables portion of factored volume is the only amount appropriate for use in the classification. Because of the recourse aspect, the balance is considered as an indirect obligation rather than a direct obligation. Any other credit accommodations to a client that are not reflected in factored receivables, such as overadvances, term loans, etc., are also appropriate for classification. Asset quality, as measured by classifications, may be influenced by seasonal aspects of clients' businesses and should be carefully analyzed allowing for such influences.

Customer Receivables Purchased by the Factor at its Own Risk

To evaluate receivables purchased by the factor at its own risk, use the aging schedule of factored receivables aggregated by customer but net of client risk receivables. Select customers for review based upon the same selections methods used for the commercial loan review. Past due volume is an essential element in evaluating customer accounts. In addition, customer files maintained by the factor should include financial statements and an analysis of the customers' financial condition.

When classifying credit exposure to a customer, factored receivables are appropriate for classification. Care should be taken not to classify any receivables that have already been classified under client risk exposure.

FORFAITING

A number of financial institutions are financing receivables from Eastern European and developing countries by a method called forfaiting.

Forfaiting is nonrecourse financing of receivables similar to factoring. However, while a factor normally purchases a company's short-term receivables, a forfait bank purchases notes that are long-term receivables with maximum maturities of eight years. The forfaiting bank has no recourse to the seller of the goods but gets the notes at a substantial discount for cash.

The centers of forfaiting are Zurich and Vienna, where many large banks, including American institutions, provide forfaiting through either their branches or specialized subsidiaries.

Forfaiting is used when government export credits or credit guarantees are not available or when a seller does not extend long-term credits to areas, such as Eastern Europe. Forfaiting is also an important method of financing for small and medium-sized companies because it enables them to negotiate transactions that would normally exceed their financial capabilities. By using forfaiting, small and medium-sized concerns can immediately sell their long-term receivables without recourse.

The examiner should review the branch's forfaiting activities carefully to determine whether long-term receivables have been purchased from countries prone to frequent political changes and fluctuations in exchange rates. In addition, the other risks peculiar to factoring are present in forfaiting, along with the risks associated with the long-term nature of receivables purchased.

U.S. AND FOREIGN RECEIVABLES GUARANTEE AND INSURANCE PLANS

To reduce credit, political, and other risks associated with foreign receivables financing, branches may avail themselves of a variety of guarantee and insurance plans, both public and private, that are available in many countries.

Because of the complexity of the numerous plans available, an examiner must frequently rely on the technical knowledge of the staff of the branch. Nevertheless, the examiner should know the risk coverage and claim adjustment provisions of the major plans. Often a branch's experience with its receivables insurance and guarantee plans indicates its effectiveness and whether the branch has properly met its responsibilities under the programs.

THE EXPORT-IMPORT BANK OF THE UNITED STATES

The Export-Import Bank of the United States (Eximbank) issues to commercial banks, for a fee, guarantees of payment for foreign receivables that the branch purchases from exporters, generally without recourse to the latter. The maturities of the receivables range from 181 days to over five years. Generally, the foreign buyer must make a cash payment, either before or upon delivery, of at least 10 percent of the invoice value and the amount of receivables purchased by the branch without recourse to the exporter normally cannot exceed 90 percent of the financed portion of the sale (invoice amount less cash payment). That guarantee covers political risks, such as inconvertibility of foreign currencies into U.S. dollars, governmental actions preventing importation of goods, war, civil strife, expropriation, and confiscation by government action. Commercial risks, basically the credit risk of the foreign purchaser, usually are covered from six months to five years.

THE FOREIGN CREDIT INSURANCE ASSOCIATION

The Foreign Credit Insurance Association (FCIA) is an association of leading marine, property, and casualty insurance companies. In cooperation with Eximbank, FCIA offers a comprehensive selection of credit insurance policies, which protect policyholders against loss from failure to receive payment from foreign buyers.

FCIA coverage protects the exporter against the failure of the buyer to pay dollar obligations for commercial or political reasons; enables the exporter to offer foreign buyers competitive terms of payment; supports the exporter's prudent penetration of higher risk foreign markets; and, gives the exporter greater financial liquidity and flexibility in administering a foreign receivables portfolio.

The FCIA does not itself finance export sales; however, the exporter who insures account receivables against commercial and political risks is usually able to obtain financing from commercial banks and other lending institutions at lower rates and on more liberal terms than would otherwise be possible by assigning the proceeds of the FCIA insurance to the lenders.

Comprehensive FCIA policies protect insurers against nonpayment of receivables due to unforeseeable commercial and political occurrences. Commercial risks that are covered include insolvency or protracted default, which may be caused by economic deterioration in the buyer's market area, shifts in demand, unanticipated competition, tariffs, or technical changes. Political risk coverage applies to defaults due to government action, such as currency inconvertibility, expropriation, and cancellation of import license and to political disturbances such as war, revolution, and insurrection.

FCIA generally offers four basic types of insurance policies covering political and commercial risks (Source: Washington Agencies that Help to Finance Foreign Trade, Seventh Edition, Bankers Trust Company, N.Y.C.):

- Short-term policies covering shipments normally sold on terms up to 180 days. The
 usual policy covers 100 percent of political
 risk and 90 percent of any losses from
 commercial risk.
- Minimum-term policies insuring transactions from six months to five years. FCIA covers up to 90 percent of commercial risks and up to 100 percent of political risks, with the remainder retained by the exporter.

- Combined short-term/medium-term policies for sales that pass through distributors before reaching final buyers.
- 4. Master policies that include the basic insurance features of the previous policies, plus discretionary and deductible provisions. Under a master policy, usually only for short-term and seldom for medium-term transactions, exporters may obtain FCIA authority to grant insured credit up to a certain amount without seeking prior approval. The deductible provision, used only for commercial risks and not political risks, requires the exporter to assume a fixed amount of the first loss on total debts.

OTHER INSURERS

There are numerous other private and governmental institutions, both in the U.S. and overseas, that guarantee or insure risks assumed by banks financing foreign receivables. Some foreign examples are the Export Credits Guarantee Department (ECGD) in the United Kingdom, COFACE in France, and HERMES in West Germany.

Financing Foreign Receivables Examination Objectives

Effective date July 1997

Section 3080.2

- To determine if the policies, practices, procedures, and internal controls regarding the financing of foreign receivables are adequate.
- To determine if branch officers are operating in conformance with established branch guidelines.
- 3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
- 4. To determine the scope and adequacy of the audit function as it relates to the financing of foreign receivables.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient.

Financing Foreign Receivables Examination Procedures

Effective date July 1997

Section 3080.3

- If selected for implementation, complete or update the Internal Control Questionnaire.
- Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
- 3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest reviews by internal and external auditors from the examiner performing the audit assignment, and determine if appropriate corrections have been made.
- 4. Obtain the following information for:
 - a. Open Account Financing:
 - Whether the shipment is directed to third parties or branches and subsidiaries of the borrower.
 - The financial strength and trustworthiness of the overseas buyer.
 - The extent of foreign exchange control and the availability of exchange for the importer to effect payment.
 - The branch's past experience in dealing with the borrower who sells on open account.

b. Sales on Consignment:

- Whether the shipment is directed to third parties or branches and subsidiaries of the obligor.
- The financial strength and trustworthiness of the foreign consignee.
- The responsibilities of the foreign sales agent, overseas representative, or import house under contract.
- The extent of foreign exchange control and the availability of exchange for that type of transaction in the country of destination.
- Whether the borrower's goods without a definite buyer are consigned abroad in the name of the borrower's bank or a foreign bank.
- Whether the goods being shipped are assigned to a responsible warehouse.
- Any arrangements that have been made whereby the selling agent negotiates for the sale of the goods.

- The regulations in the country of destination regarding the return of unsold consigned goods to the country of origin.
- The branch's past experience in dealing with the borrower who sells on consignment.
- c. Advances Against Collections:
 - The relationship between the amount collected in a month on the collections pledged as collateral and the borrower's credit limit.
 - The tenor of sight drafts stated number of days after sight or a stated number of days after the date of the draft.
 - Instructions regarding delivery of documents against payment (D/P) or documents against acceptance (D/A).
 - Whether amounts advanced against collections are within the percentage of advance limitation established.
 - Aging of drafts (collections).
 - Ineligible drawees, including house bills.
 - · Concentrations of drawees.
 - · Financial strength of drawees.
 - Unusual situations such as disputes, nonacceptance of goods, and possession of goods without payment.
 - · Dishonor and protest instructions.
 - Any special instructions.
 - The extent of foreign exchange controls and the availability of exchange for that type of transaction in the country of destination.
 - The branch's experience in dealing with the borrower who receives advances against collections.
- d. Discounted Trade Acceptances:
 - The relationship between the amount collected in a month on the trade acceptances discounted and the borrower's credit limit.
 - Whether the branch discounted the trade acceptance with or without recourse.
 - Whether the borrower retains a percentage of the trade acceptance endorsed to the branch.
 - · Aging of trade acceptances.
 - Ineligible drawees, including house bills

- · Concentrations of drawees.
- · Financial strength of the drawees.
- Unusual situations, such as disputes, nonacceptance of goods, and possession of goods without payment.
- · Dishonor and protest instructions.
- · Any special instructions.
- The extent of foreign exchange controls and the availability of exchange for that type of transaction in the country of destination.
- The branch's experience in dealing with the borrower for whom its trade acceptances are discounted by the branch.
- e. Banker's Acceptance Financing:
 - The relationship between the amount collected from the foreign buyer in a month and the borrower's credit limit.
 - Whether the discounted draft drawn by the exporter (customer) on the exporter's bank has the same tenor as the draft addressed to the foreign buyer.
 - The procedures for applying payment received from the foreign buyer to pay the branch's own acceptance.
 - Aging of time drafts drawn on the importer (drawee).
 - Ineligible foreign buyers (drawees), including house bills.
 - Concentrations of foreign buyers
 - Financial strength of the foreign buyers (drawees).
 - Disputes, nonacceptance of goods, and possession of goods without payment.
 - Dishonor and protest instructions.
 - · Any special instructions.
 - The extent of foreign exchange control and the availability of exchange for that type of transaction in the country of destination.
 - The branch's experience in dealing with the borrower.

f. Factoring:

- The extent of factor guarantees (letters of credit opened by the branch in favor of overseas suppliers).
- Whether the title documents on import transactions are consigned to or endorsed over to the factor.
- Whether the importer who receives goods under trust receipt agrees to hold them in trust for the factor.

- Whether the imported goods held under warehouse receipt are stored in an independent warehouse for the account of the factor.
- Whether banker's acceptances are charged to the branch customer's account for payment to the factor when due.
- Whether the factor creates a banker's acceptance pending payment of accounts receivable resulting from the sale of goods imported under letters of credit.
- The financial strength of the importer for whom the branch opened the letter of credit.
- Any disputes, nonacceptance of goods, and possession of goods without payment.
- The branch's experience in dealing with the factor.

g. Forfaiting:

- Agings of debtor accounts purchased.
- Ineligible debtor accounts purchased, including affiliate receivables, if any.
- Concentration of debtor accounts purchased.
- The adequacy of the branch's credit investigation before approving the sale (or signing of a sales contract) creating a receivable.
- The financial strength of the debtor accounts purchased.
- The capability of the exporter from whom receivables were purchased to provide any required after-sales service and to honor warranties.
- · Disputes and returns.
- The extent of foreign exchange restrictions, availability of exchange, and country risk involved that could jeopardize collection of receivables purchased.
- The branch's experience in dealing with both the debtors and the exporter.
- h. U.S. and foreign receivables guarantee and insurance plans:
 - Whether foreign receivables coverage by FCIA, Eximbank, or other insurance or guarantee programs is sufficient, adequately identifies risks, and is consistent with established limits.
- Analyze secondary support offered by guarantors and endorsers.

- Determine compliance with the branch's established loan policy.
- 7. At this point, the examiner needs to decide whether further examination and testing is needed. If further work is warranted, refer to the audit guidelines. After reviewing the audit guidelines, proceed to step 8.
- Discuss with appropriate officers and prepare summaries in appropriate report form of:
 - a. Delinquent loans.
 - b. Loans not supported by current and complete financial information.
 - c. Loans on which documentation is deficient.
 - d. Loans with credit weaknesses.
 - e. Inadequately collateralized loans.
 - f. Criticized loans, including supporting commentaries.

- g. Concentrations of credit.
- h. Other matters regarding the condition of the department.
- 9. Evaluate the branch with respect to:
 - a. The adequacy of written policies relating to financing foreign receivables.
 - The manner in which branch officers are operating in conformance with established policy.
 - c. Adverse trends in those sections concerned with financing foreign receivables.
 - d. Recommended corrective action when policies, practices, or procedures are deficient.
 - e. The competency of departmental management,
 - f. Other matters of significance.
- 10. Update the workpapers with any information that will facilitate future examinations.

Financing Foreign Receivables Internal Control Questionnaire

Effective date July 1997

Section 3080.4

POLICIES

- 1. Has the head office adopted policies that:
 - a. Establish procedures for reviewing financing applications?
 - b. Establish standards for determining credit lines?
 - c. Establish standards for determining the percentage of advances made against acceptable collections (receivables)?
 - d. Define acceptable receivables (collections)?
 - e. Establish minimum requirements for verification of borrower's receivables (collections)?
 - f. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
- 2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

ACCOUNTING RECORDS

If the following questions have been answered in the Credit Risk section (3010), skip to question 9.

- Is the preparation and posting of subsidiary records performed or adequately reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
- 4. Are subsidiary records reconciled, at least monthly, with the appropriate general ledger accounts, and are reconciling items adequately investigated by persons who do not normally handle foreign receivables financing?
- 5. Are inquiries regarding loan balances for foreign receivables financing received and investigated by persons who do not normally process documents, handle settlements, or post records?
- 6. Are bookkeeping adjustments checked and approved by an appropriate officer?
- 7. Is a daily record maintained summarizing transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger entries?

8. Are frequent debt instrument and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

DOCUMENTATION

- 9. Are terms, dates, weights, description of the merchandise, etc., shown on invoices, shipping documents, trust receipts, and bills of lading scrutinized for differences?
- 10. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
- 11. Are payments received from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

LOAN INTEREST

If the following questions have been answered in the Credit Risk section (3010), skip to question 14.

- 12. Is the preparation and posting of loan interest records performed or adequately reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
- 13. Are independent interest computations made and compared or adequately tested to initial loan interest records by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?

COLLATERAL

- 14. Does the branch record a first lien on assigned foreign receivables for each borrower on a timely basis?
- 15. Do loans granted on the security of the foreign receivables also have an assignment of the inventory?
- 16. Does the branch verify the borrower's receivables or require independent verification on a periodic basis?

- 17. Does the branch require the borrower to provide aged receivables schedules on a periodic basis?
- 18. Are underlying bills of lading covering shipments either to the order of the shipper or blank endorsed to the order of the branch rather than the foreign buyer?
- 19. Are the shipments being financed covered by adequate insurance?

ADVANCES AGAINST COLLECTIONS AND DISCOUNTED TRADE ACCEPTANCES

- 20. Are permanent registers kept for foreign collections against which advances were made or trade acceptances were discounted?
- 21. Are all collections indexed in a collection register?
- 22. Do these registers furnish a complete history of the origin and final disposition of each collection against which advances were made or trade acceptances were discounted?
- 23. Are receipts issued to loan customers for all collections received from them?
- 24. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
- 25. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collections?
- 26. Is a daily record maintained showing the various collections that have been paid and credited to the borrower's advance?
- 27. Are proceeds of paid collections credited to the correct customer's advance?
- 28. Is an itemized daily summary made of all interest charged and received from the exporter or importer (drawee) indicating underlying collection numbers and amounts?
- 29. Are payments collected from importers (drawees) by foreign banks or branches of U.S. banks forwarded directly to the branch and not through the exporter?
- 30. If the exporter accepts importer (drawee) payments directly, are controls established or audits of exporter's books conducted? If so, explain briefly.
- 31. Are employees handling collections periodically rotated, without advance notification, to other banking duties?

- 32. Is the employee handling collection proceeds required to apply them to the borrower's advance on the same business day that payment is received?
- 33. Is the disposition of each collection noted on the register so that verification of disposition can be made?
- 34. Has a regular policy of follow-up procedures been established for sending tracers and inquiries on unpaid collections in the hands of correspondents?
- 35. Should the foreign drawee refuse to honor the draft, are instructions clear as to what actions should be taken by the collecting bank?
- 36. In the event of nonpayment of the collection, is the borrower promptly notified by the branch?
- 37. Are collections against which advances have been made or trade acceptances discounted distinctly segregated from ordinary collection items?
- 38. Are financed collections maintained under memorandum control and is the control balanced regularly?
- 39. Are collections against which advances have been made or trade acceptances discounted booked by persons other than employees handling those items?
- 40. Are collections carried over to the next business day adequately secured?
- 41. Does the customer for whom trade acceptances were discounted know whether they were purchased with or without recourse to that customer?
- 42. Do all parties, i.e., the seller (exporter), importer (buyer), and banks, clearly understand whether interest, discount, and collection charges are to be absorbed by the seller or paid by the importer?

FACTORING

- 43. Has the branch properly surrendered the shipping documents to the factor either through endorsement or consignment?
- 44. Do advances or banker's acceptances coincide with the expected payment of the accounts receivable by the ultimate customer?

FOREIGN CREDIT INSURANCE ASSOCIATION INSURANCE

- 45. Is the branch aware of risks not covered under its assigned FCIA insurance?
- 46. Does the branch monitor whether the borrower exceeded its FCIA established credit limits?
- 47. Does the branch monitor whether the borrower properly assigned the proceeds of its FCIA insurance to the branch?
- 48. Is the branch aware of whether the FCIA insurance is on either simple notice or a special assignment basis?
- 49. Does the branch retain recourse to the exporter under its FCIA arrangement?
- 50. Has the branch reported delinquencies to FCIA in accordance with its agreement with the Association?
- 51. If default occurs, does the branch file a proper claim with FCIA?

EXPORT-IMPORT BANK OF THE UNITED STATES

52. Does the branch, financing under Eximbank arrangements, have properly executed Eximbank guarantees or commitments covering transactions?

- 53. If the branch has discretionary authority from Eximbank, does it nevertheless inform Eximbank of each transaction thereunder?
- 54. If the branch has been issued an equipment political risk guarantee by Eximbank, does it have a written statement from the government of the country in which the equipment will be used indicating that it will permit the importation, use, and any subsequent exportation of the equipment?
- 55. Does the branch monitor whether loan agreements between applicable borrowers and the branch are acceptable to Eximbank?
- 56. Does the branch report delinquencies to Eximbank in a timely manner, as specified in its agreement with that agency?
- 57. If default occurs, does the branch file a proper claim with Eximbank?

CONCLUSION

- 58. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Financing Foreign Receivables Audit Guidelines

Effective date July 1997

Section 3080.5

- Test the addition of trial balances and their reconciliation to the general ledger. Include loan commitments and other contingent liabilities.
- If memoranda controls are maintained, prepare a trial balance of each account so controlled. Using an appropriate sampling technique, select representative items and:
 - a. Review all supporting documents.
 - Verify the authenticity of each item selected and trace and clear each item through final payment, including appropriate credit to the customer's account.
 - c. In the case of unusual, altered, or longstanding items, prepare and mail confirmation requests to customers.
 - Examine financing instruments for completeness and verify dates, amounts, and items to the trial balance.
 - e. Check to see that financing instruments are signed, appear to be genuine, and are negotiable.
 - Check to see that required initials of an approved lending officer are on the financing instrument.
 - g. Determine that the amount is within the officer's lending limit.
 - h. Determine that any necessary insurance coverage is adequate and that the branch is named as loss payee.
 - i. Review disbursement ledgers and authorizations to determine if:
 - Authorizations are signed in accordance with the terms of the loan agreement.
 - Collection funds received are credits in accordance with provisions of the borrower's loan agreement.

- Determine that records are posted promptly on collections settled, preferably on the same day they are received.
- 3. Review the applicable accrued interest accounts by:
 - Reviewing and testing procedures of accounting for accrued interest and for handling adjustments.
 - Scanning accrued interest for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.
 - c. Independently calculating for those credit extensions selected in step 2, the amount of accrued interest and confirming the amount to the detail of accrued interest receivable for that loan.
- Using a list of nonaccruing loans, check accrual records to determine that interest income is not being recorded.
- Test appropriate records to determine that discount, commissions, fees, and collection charges are in accordance with established amounts and that the income accounts are properly credited.
- Obtain or prepare a schedule showing the monthly interest income amounts and applicable loan balances at each month-end since the last audit and:
 - a. Calculate yield.
 - b. Investigate significant fluctuations and trends

Effective date July 1997

A branch's authority to hold real estate rests with the laws of its respective state (if state licensed) or the National Banking Act (if federally licensed). State and federal laws and regulations may dictate accounting procedures, maximum holding periods, and other details relating to other real estate owned. Examiners should follow the most recent interagency guidelines when verifying the proper identification, reporting, valuation, and accounting for disposal of other real estate owned (OREO).

Relevant interagency joint statements include "Interagency Guidance on Accounting for Dispositions of Other Real Estate Owned," dated July 16, 1993, and "Interagency Guidance on Reporting of In-Substance Foreclosures," dated June 10, 1993. In addition, refer to the final rule entitled "Real Estate Lending Standards," promulgated by the Federal Reserve Board, FDIC, OTS, and OCC in December 1992. See Final Rule, 57 Fed. Reg. 62890 (December 31, 1992). The various state and federal agencies may differ in terms of specific practices and methodologies used to implement the above guidelines. For further guidance in this area, examiners should consult with their respective agencies.

Real property becomes other real estate owned through:

- Conveyance in satisfaction of debts previously contracted;
- Exchange for future advances to an existing borrower to fully or partially satisfy debts previously contracted;
- Purchase to secure debts previously contracted;
- · Relocation of branch premises; or
- Abandonment of plans to use real estate acquired for future expansion for banking premises.

Although the borrower may still retain possession and legal title to the property, certain troubled loans secured by real estate are considered to be "insubstance foreclosures" and are also treated as other real estate owned. An insubstance foreclosure situation is generally characterized by a borrower with little or no equity and the sale of the property is the only source of repayment.

ENVIRONMENTAL LIABILITY

Under federal and state environmental liability statutes, a branch may be liable for cleaning up hazardous substance contamination of other real estate owned. In some cases, the liability may arise before the branch takes title to a borrower's collateral real estate. A property's transition from collateral to branch ownership may take an extended period of time. As the financial problems facing a borrower worsen, a branch may become more involved in managing a company or property. Such involvement may become extensive enough that the branch is deemed to have met substantially all ownership criteria, the absence of a clear title in the branch's name notwithstanding. Generally, the more involved branch management is in such activity, the greater the branch's exposure to any future clean-up costs assessed in connection with the property. A more thorough discussion of environmental liability can be found in the Real Estate Loans section of this manual.

TRANSFER OF ASSETS TO OTHER REAL ESTATE OWNED

Real estate assets transferred to OREO should be accounted for individually on the date of transfer, at the lower of the recorded investment in the loan or fair value. The recorded investment in a loan is the unpaid balance, increased by accrued and uncollected interest, unamortized premium, finance charges, and loanacquisition costs, if any, and decreased by previous write-downs and unamortized discount, if any. Any excess of the recorded investment in the loan over the property's fair value must be charged against the allowance for loan and lease losses immediately upon the property's transfer to OREO. Legal fees should generally be charged to expenses unless payment of the fees is for the purpose of enhancing the property's value (for example, obtaining a zoning variance).

Establishing a valuation allowance for estimated selling expenses may also be necessary upon transferring each property to OREO to comply with AICPA Statement of Position 92-3, Accounting for Foreclosed Assets. According to this pronouncement, the value of OREO properties must be reported at the lesser of the fair

value minus estimated selling expenses or the recorded investment in the loan. For example, if the recorded investment of the property is \$125, the fair value is \$100, and the estimated selling expenses are \$6, the carrying value for this property would be \$94. The difference between the recorded investment and the fair value (\$25) would be charged to the allowance for loan and lease losses at the time the property was transferred to OREO. In addition, since the branch estimated it would incur selling expenses of \$6, a valuation reserve for this amount must be established. The net of the fair value and this valuation reserve for selling expenses is called the "net realizable value," and in this example would be \$94. Changes to this valuation reserve should be handled as outlined in the subsection "Accounting for Subsequent Changes in Market Value."

On the other hand, if the recorded investment in the property is \$250, the fair value is \$300, and the estimated selling expenses are \$18, the carrying value of this property would be \$250 (the lesser of the recorded investment or the fair value). In this example, a valuation reserve for estimated selling expenses is unnecessary, as netting the estimated selling expenses (\$18) from the fair value (\$300) would yield a net realizable value of \$282.

The transfer of a loan to OREO is considered to be a "transaction involving an existing extension of credit" under 12 CFR 225.63(a)(7) and is exempt from Regulation Y's appraisal requirement. However, under 12 CFR 225.63(b), the branch must obtain an "appropriate evaluation" of the real estate that is "consistent with safe and sound banking practices" to establish the carrying value of the OREO. A branch may elect, but is not required, to obtain an appraisal to serve as the "appropriate evaluation." Until the evaluation is available, a branch should rely on its best estimate of the property's value to establish the carrying value. The federal banking agencies have issued appraisal and evaluation guidelines to provide guidance to examining personnel and federally regulated institutions regarding prudent appraisal and evaluation policies, procedures, practices, and standards.

The appraisal or evaluation should provide an estimate of the parcel's market value. Refer to Real Estate Loans section of this manual for a definition of market value. Generally, market value and fair value are equivalent when an active market exists for a property. In discussing

OREO, it is common practice to use the terms "fair value" and "market value" interchangeably. When no active market exists for a property, the accounting industry's definition of fair value applies because the appraiser cannot determine a market value. The accounting industry definition requires the appraisal or evaluation to contain an estimate of the property's fair value based on a forecast of expected cash flows, discounted at a rate commensurate with the risks involved. The cash flow estimate should include projected revenues and the costs of ownership, development, operation, marketing, and sale. In such situations, the appraiser or evaluator should fully describe the definition of value and the market conditions that have been considered in estimating the property's value.

When a branch acquires a property through foreclosure as a junior lienholder, whether or not the first lien has been assumed, the fair value of the property should be recorded as an asset and the senior debt as a liability. The senior debt should not be netted against the assets. Any excess of the recorded investment of the property over the fair value should be charged off, as the recorded investment may not exceed the sum of the junior and senior debt. Payments made on senior debt should be accounted for by reducing both the asset and the liability, and interest that accrues on the senior debt after foreclosure should be recognized as interest expense.

For regulatory reporting purposes, a collateral-dependent real estate loan should be transferred to OREO only when the lender has taken possession (title) of the collateral. Nevertheless, to facilitate administration and tracking, branches may choose to include a collateral-dependent real estate loan in the OREO portfolio as potential or probable OREO. Examiners should review these loans using the same criteria applied to OREO.

CARRYING VALUE OF OTHER REAL ESTATE OWNED

A branch should have a policy for periodically determining the fair value of its OREO property by obtaining an appraisal or an evaluation, as appropriate. While the Federal Reserve has no prescribed time frame for when a branch should reappraise or reevaluate its OREO property, the branch's policy should conform to state or

federal law, if applicable, and address the volatility of the local real estate market. Specifically, a branch should determine if there have been material changes to the underlying assumptions in the appraisal or valuation that have affected the original estimate of value. If material changes have occurred, the branch should obtain a new appraisal or evaluation based on assumptions that reflect the changed conditions.

ACCOUNTING FOR SUBSEQUENT CHANGES IN MARKET VALUE

Charges for subsequent declines in the fair value of OREO property should never be posted to the allowance for loan and lease losses. If an appraisal or evaluation indicates a subsequent decline in the fair value of an OREO property, the loss in value should be recognized by a charge to earnings. Branches should attempt to determine whether a property's decline in value is temporary or permanent, taking into consideration each property's characteristics and existing market dynamics. The preferred treatment for permanent losses in value is the direct write-down method, in which the charge to expenses is offset by a reduction in the OREO property's carrying value. If the reduction in value is deemed temporary, the charge to earnings may be offset by establishing a valuation allowance specifically for that property. In the event of subsequent appreciation in the value of an OREO property, the increase can only be reflected by reducing this valuation allowance or recognizing a gain upon disposition, but never by a direct write-up of the property's value. A change to the valuation allowance should be offset with a debit or credit to expense in the period in which it occurs.

In addition to the preceding treatment of the write-down in the OREO value, the previous subsection "Transfer of Assets to Other Real Estate Owned" discusses setting up a valuation allowance for estimated selling expenses associated with the sale of the other real estate. The balance of this valuation reserve can fluctuate based on changes in the fair value of the property held, but it can never be less than zero. The following examples are presented to illustrate the treatment that subsequent depreciation and appreciation would have on OREO properties.

Depreciation in OREO Property Value

Assume a branch has written down its initial recorded investment in an OREO property from \$125 to its fair value of \$100. Since the fair value of the property was less than the initial recorded investment, a valuation reserve for estimated selling expenses was established. In this example, assume these to be \$6. Accordingly, the net realizable value was \$94 (\$100 minus \$6). Next, assume a new appraisal indicates a fair value of \$90, reducing the estimated selling expenses to \$5. Although the branch must expense the depreciation in the fair value (\$10), the valuation reserve for selling expenses would be reduced by the difference in the estimate of the selling expenses (\$1). Given this scenario, the "adjusted" net realizable value would be \$85 (\$90 minus \$5).

Appreciation in OREO Property Value

Assume a branch has written down its recorded investment in an OREO property to its fair value of \$100. Since the fair value of the property was less than the original recorded investment, an estimated valuation reserve for selling expenses of \$6 was established. Accordingly, the net realizable value was \$94. A new appraisal indicates an increase in the fair value of the property to \$110, with selling expenses now estimated at \$7. As a result, the net realizable value is now \$103. Given that the new net realizable value is greater than the recorded investment of \$100, the selling expense valuation reserve is no longer necessary and the \$6 can be reversed to income. Notwithstanding the property's increased fair value, the recorded investment value cannot be increased above \$100. The valuation reserve for selling expenses can never be less than zero, thus prohibiting an increase in the value of the property above the recorded investment.

ACCOUNTING FOR INCOME AND EXPENSE

Gross revenue from other real estate owned should be recognized in the period in which it is earned. Direct costs incurred in connection with holding an OREO property, including legal fees, real estate taxes, depreciation, and direct writedowns, should be charged to expense when incurred.

A branch can expend funds to develop and improve OREO when it appears reasonable to expect that any shortfall between the property's fair value and the branch's recorded book value will be reduced by an amount equal to or greater than the expenditure. Such expenditures should not be used for speculation in real estate. The economic assumptions relating to the branch's decision to improve a particular OREO property should be well documented. Any payments for developing or improving OREO property are treated as capital expenditures and should be reflected by increasing the property's carrying value.

DISPOSITION OF OTHER REAL ESTATE OWNED

OREO property must be disposed of within any holding period established by state law and, in any case, as soon as it is prudent and reasonable. Branches should maintain documentation reflecting their efforts to dispose of OREO property, which should include a record of inquiries and offers made by potential buyers, methods used in advertising the property for sale whether by the branch or its agent, and other information reflecting sales efforts.

The sale or disposition of OREO property is considered a real estate-related financial transaction under the Board's appraisal regulation. A sale or disposition of an OREO property that qualifies as a federally related transaction under the regulation requires an appraisal conforming to the regulation. A sale or disposition that does not qualify as a federally-related transaction nonetheless must comply with the regulation by having an appropriate evaluation of the real estate, that is consistent with safe and sound banking practices.

The branch should promptly dispose of OREO if it can recover the amount of its original loan plus additional advances and other costs related to the loan or the OREO property before the end of the legal holding period. The holding period generally begins on the date that legal title to the property is transferred to the branch, except for real estate that has become OREO because the branch no longer contemplates using it as its premises. The holding period for this type of

OREO property begins on the day that plans for future use are formally terminated. Some states require OREO property to be written off or depreciated on a scheduled basis, or to be written off at the end of a specified time period. The branch should determine whether such requirements exist and comply with them.

ACCOUNTING FOR THE SALE OF OTHER REAL ESTATE OWNED

Gains and losses resulting from a sale of OREO properties for cash must be recognized immediately. A gain resulting from a sale in which the branch provides financing should be accounted for under the standards described in Statement of Financial Accounting Standards 66 (SFAS 66).

SFAS 66 recognizes that differences in terms of the sale and in selling procedures lead to different profit recognition criteria and methods. Branches may facilitate the sale of foreclosed real estate by requiring little or no down payment, or by offering loans with favorable terms. Profit shall only be recognized in full when the collectibility of the sales price is reasonably ensured and when the seller is not obligated to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be deferred. Collectibility of the sale price of OREO property is demonstrated when the buyer's investment is sufficient to assure that the buyer will be motivated to honor his or her obligation to the seller rather than lose the investment. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

The practice of recognizing all profit from the sale of branch-financed OREO at the time of the sale is referred to as the full-accrual method. A branch shall not recognize profit using this method until all of the following general criteria are met:

- A sale is consummated.
- The buyer's initial and continuing investments adequately demonstrate a commitment to pay for the property.
- The branch's loan is not subject to future subordination.

 The branch has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale, and it has no substantial continuing involvement in the property.

A sale will not be considered consummated until the parties are bound by the terms of the contract, all consideration has been exchanged, and all conditions precedent to closing have been performed.

Initial investment, as defined by SFAS 66, includes only cash down payments, notes supported by irrevocable letters of credit from an independent lending institution, payments by the buyer to third parties to reduce existing debt on the property, and other amounts paid by the buyer that are part of the sale price. In these situations, SFAS 66 requires that profit on the sale be deferred until a minimum down payment has been received and annual payments equal those for a loan for a similar type of property with a customary amortization period. The amount of down payment required varies by category of property: land, 20-25 percent; commercial and industrial, 10-25 percent; multifamily residential, 10–25 percent; and single-family residential, 5-10 percent. Ranges within these categories are defined further in the statement.

Continuing investment requires the buyer to be contractually obligated to make level annual payments on his or her total debt for the purchase price of the property. This level annual payment must be able to service principal and interest payments amortized for no more than 20 years for raw land, and for no more than the customary amortization term for a first-mortgage loan by an independent lending institution for other types of real estate.

If a branch finances the sale of foreclosed property it owns with a loan at less than current market interest rates or noncustomary amortization terms, generally accepted accounting principles require that the loan be discounted to bring its yield to a market rate, using a customary amortization schedule. This discount will either increase the loss or reduce the gain resulting from the transaction. Interest income is then generally recognized at a constant yield over the life of the loan.

If a transaction does not qualify for the full-accrual accounting method, SFAS 66 identifies alternative methods of accounting for sales of OREO property as described below.

The Installment Method

This method is used when the buyer's down payment is insufficient to allow the full-accrual method, but when recovery of the cost of the property is reasonably assured if the buyer defaults. The installment method recognizes the sale of the property and the booking of the corresponding loan, although profits from the sale are recognized only as the branch receives payments from the buyer. Under this method, interest income is recognized on an accrual basis, when appropriate.

Since default on the loan usually results in the seller (the branch) reacquiring the real estate, the branch is reasonably assured that it will be able to recover its costs with a relatively small down payment. Cost recovery is especially likely when loans are made to buyers who have verifiable net worth, liquid assets, and income levels adequate to service the loan. Reasonable assurance of cost recovery also may be achieved when the buyer pledges adequate additional collateral.

The Cost-Recovery Method

Dispositions of OREO that do not qualify for either the full-accrual or installment methods are sometimes accounted for using the cost-recovery method. This method recognizes the sale of the property and the booking of the corresponding loan, but all income recognition is deferred. Principal payments are applied by reducing the loan balance, and interest payments are accounted for by increasing the unrecognized gross profit. No profit or interest income is recognized until either the buyer's aggregate payments exceed the recorded amount of the loan or a change to another accounting method (for example, the installment method) is appropriate. Consequently, the loan is maintained on nonaccrual status while this method is being used.

The Reduced Profit Method

This method is used in certain situations when the branch receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full-accrual method. The branch again recognizes the sale of the property and the booking of the corresponding loan but, as under the installment method, profits from the sale are recognized only as the branch receives payments from the buyer. Since sales with adequate down payments generally are not structured with inadequate loanamortization schedules, this method is seldom used.

The Deposit Method

This method is used when a sale of OREO has not been consummated. It also may be used for dispositions that could be accounted for under the cost-recovery method. Under this method, a sale is not recorded, so the asset continues to be reported as OREO. Further, no profit or interest income is recognized. Payments received from the buyer are reported as a liability until the use of one of the other methods is appropriate.

Branches may promote the sale of foreclosed real estate by offering nonrecourse financing to buyers. These loans should be made under the same credit terms and underwriting standards the branch employs for its regular lending activity. Financing arrangements associated with this type of transaction are subject to the accounting treatment discussed above.

Branch records should (1) indicate the accounting method used for each sale of OREO, (2) support the choice of the method selected, and (3) sufficiently document that the institution is correctly reporting associated notes receivable, as either loans or OREO property, with valuation allowances as appropriate.

CLASSIFICATION OF OTHER REAL ESTATE OWNED

The examiner should generally evaluate the quality of each OREO property to determine if classification is appropriate. OREO usually should be considered a problem asset, even when it is carried at or below its appraised value. Despite the apparent adequacy of the fair or market value, the branch's acquisition of OREO through foreclosure usually indicates a lack of demand. As time passes, the lack of demand can become more apparent, and the value of the real estate can become increasingly questionable.

When evaluating the OREO property for classification purposes, the examiner must consider the property's market value, whether it is being held in conformance with state law, and whether it is being disposed of according to the branch's plan. The amount of an OREO property subject to classification is the carrying value of the property, net of any specific valuation allowance. The existence of a specific valuation allowance does not preclude adverse classification of OREO. The examiner should review all types of OREO for classification purposes. including sales that fail to meet the standards required for the full-accrual method of accounting. When the branch provides financing, the examiner should determine whether it is prudently underwritten.

The examiner should review all relevant factors to determine the quality and risk of the OREO property and the degree of probability that its carrying value will be realized. Some factors the examiner should consider include:

- The property's carrying value relative to its market value (including the date of any appraisal or evaluation relative to changes in market conditions), the branch's asking price, and offers received:
- The source and quality of the appraisal or evaluation, including the reasonableness of assumptions, such as projected cash flow for commercial properties;
- The length of time a property has been on the market and local market conditions for the type of property involved, such as history and trend of recent sales for comparable properties;
- Branch management's ability and track record in liquidating other real estate and assets acquired in satisfaction of debts previously contracted;
- Income and expenses generated by the property and other economic factors affecting the probability of loss exposure;
- The manner in which the branch intends to dispose of the property; and
- Other pertinent factors, including propertytitle problems, statutory redemption privileges, pending changes in the property's zoning, environmental hazards, other liens, tax status, and insurance.

Other Real Estate Owned Examination Objectives

Effective date July 1997

Section 3090.2

- To determine if the policies, practices, procedures, and internal controls regarding other real estate owned are adequate.
- To determine that branch officers and employees are operating in conformance with the established guidelines.
- 3. To verify the carrying value of all other real estate owned.
- To determine the scope and adequacy of the internal/external audit function.
- 5. To determine compliance with applicable laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Other Real Estate Owned

Examination Procedures

Effective date July 1997

Section 3090.3

- If included in the scope of the examination, complete or update the Internal Control Ouestionnaire.
- Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any audit deficiencies noted in the latest review by internal/external auditors, and determine if appropriate corrections have been made.
- 3. Obtain a list of other real estate owned and reconcile the total to the general ledger.
- 4. Review the other real estate owned account to determine if any property has been disposed of since the prior examination and:
 - a. If so, determine that:
 - The branch accepted written bids for the property.
 - The bids are maintained on file.
 - There is justification for accepting a lower bid if the branch did not accept the highest one.
 - b. Investigate any insider transactions.
- 5. Test compliance with applicable laws and regulations:
 - Determine that other real estate owned is held in accordance with the provisions of applicable state or federal laws and regulations.
 - Determine if other real estate is being amortized or written off in compliance with applicable state or federal laws and regulations.
 - c. Consult with the examiners assigned to "Loan Portfolio Management," "Other Assets (and Other Liabilities)," and "Bank Premises and Equipment" to determine:
 - If the branch holds real estate acquired as salvage on uncollectible loans, abandoned bank premises, or property originally purchased for future expansion but which is no longer intended for such usage.
 - If troubled real estate loans meeting the criteria for in-substance foreclosures and covered transactions are identified.
 - If covered transactions and in-substance foreclosures are being properly accounted for and reported as other real estate owned.

- d. Review the details of all other real estate owned transactions to determine that:
 - The property has been booked at its fair value.
 - The documentation reflects the branch's persistent and diligent effort to dispose of the property.
 - If the branch has made expenditures to improve and develop other real estate owned, proper documentation is in the file.
 - Real estate that is former banking premises has been accounted for as other real estate owned since the date of its abandonment.
 - Such property is disposed of in accordance with state or federal laws and regulations, including Regulation Y.
 - The valuation is not affected by an Environmental Protection Agency issue.
- 6. Review parcels of other real estate owned with appropriate management personnel and, if justified, assign appropriate classification. Classification comments should include:
 - a. Description of property.
 - b. How and when real estate was acquired.
 - c. Amount and date of appraisal.
 - d. Amount of any offers and branch's asking price.
 - e. Other circumstances pertinent to the classification.
- 7. Review the following with appropriate management personnel or prepare a memo to other examiners for their use in reviewing with management:
 - a. Internal control exceptions and deficiencies in, or noncompliance with, written policies, practices, and procedures.
 - b. Uncorrected audit deficiencies.
 - c. Violations of law.
- 8. Prepare comments in appropriate report form for all:
 - a. Criticized other real estate owned.
 - b. Deficiencies noted.
 - c. Violations of law.
- 9. Update the workpapers with any information that will facilitate future examinations.

Other Real Estate Owned Internal Control Questionnaire Effective date July 1997

Section 3090.4

OTHER REAL ESTATE OWNED RECORDS

- Are postings to the general ledger account for other real estate owned approved and/or tested, prior to posting, by persons who do not have direct, physical, or accounting, control of those assets?
- 2. Are the subsidiary records for other real estate owned balanced at least quarterly to the appropriate general ledger accounts by persons who do not have direct, physical, or accounting control of those assets?
- 3. Are supporting documents maintained for all entries to other real estate owned accounts?
- 4. Are acquisitions and disposals of other real estate owned reported to senior management at the head office?
- 5. Does the branch maintain insurance coverage on other real estate owned, including liability coverage where necessary?
- 6. Are all parcels of other real estate owned reviewed at least annually for:
 - a. Current appraisal or certification?
 - b. Documentation inquiries and offers?
 - c. Documented sales efforts?
 - d. Evidence of the prudence of additional advances?

- e. Anticipated methods for disposal of property?
- f. Changes in tax status, zoning restrictions, other liens, etc.?

OTHER PROCEDURES

- 7. Does the branch have written policies and procedures relating to other real estate owned?
- 8. Does the branch factor in Environmental Protection Agency issues and their impact on valuation into its policies?

CONCLUSION

- Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Other Real Estate Owned Audit Guidelines

Effective date July 1997

Section 3090.5

- Test the additions of the subsidiary ledgers and reconcile the total to the general ledger. Include insubstance foreclosures and property sold in "covered transactions."
- 2. Using appropriate sampling techniques, select specific properties and determine that:
 - a. Legal title to the property is obtained when the asset is recorded as other real estate owned.
 - b. Legal fees and direct costs of acquiring title, including payment of existing liens, taxes, and recording fees are expensed when incurred and are not capitalized.
 - Insurance, including liability coverage, is adequate and the branch is named as loss payee.

- 3. Using appropriate sampling techniques, select specific properties, and for expenses incurred in maintaining the properties or capitalized costs of improvement and development:
 - Trace the transaction to any previous records and to postings in the general ledger.
 - Examine documentation supporting the transaction and prove any computations reflected on the supporting document.

Effective date July 1997

Real estate lending is a major function of some branches. However, the composition of real estate loan portfolios will vary from branch to branch because of differences in strategic direction, asset size, lending experience, market conditions, and location. This section of the manual deals with the permanent financing of residential and commercial real estate. Also included in this section are discussions on real estate appraisals and environmental liability. Real estate construction lending is discussed separately in the following section of this manual.

Due to the differences in individual state banking laws, this section of the manual provides a general overview of the supervisory and regulatory requirements for a safe and sound real estate lending program. For information on lending limitations and restrictions, refer to the applicable banking laws and regulations that govern federally-insured and state-licensed branches.

REAL ESTATE LENDING POLICY

The branch's real estate lending policy is a broad statement of the standards, guidelines, and limitations that senior branch management and lending officers are expected to adhere to in the process of making a real estate loan. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation is essential to the branch's management of the real estate lending function.

The policies governing a branch's real estate lending activities must include prudent underwriting standards that are periodically reviewed by head office management and clearly communicated to the branch's management and lending staff. The branch should also have credit risk control procedures that include, for example, prudent internal limits on exposure and an effective credit review and problem loan identification process. The complexity and scope of these policies and procedures should be appropriate to the size of the branch and the nature of the branch's activities, and should be consistent with prudent banking practices and relevant regulatory requirements. As part of the analysis of a branch's real estate loan portfolio, examiners should review lending policies, loan administration procedures, and credit risk control procedures as well as the branch's compliance with its policy.

On March 19, 1993, a uniform rule on real estate lending by insured depository institutions promulgated by the federal banking agencies became effective. Although the rule does not directly apply to uninsured branches, it should be used as a general supervisory guide when reviewing loan portfolios, procedures, and practices at all branches. The rule requires each insured depository institution to adopt and maintain comprehensive written real estate lending policies that are consistent with safe and sound banking practices, are appropriate to the size of the institution, and the nature and scope of its operations. The policies must establish loan-tovalue limits; loan administration procedures; portfolio diversification standards; and documentation, approval, and reporting requirements. The policies adopted by the branch should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies established by the federal banking agencies. In addition to the requirements of the uniform rule, a branch's real estate lending policy should include principal amortization terms acceptable for each type of real estate loan that the branch underwrites. Branch management should also ensure that loans are granted with the reasonable expectation that the borrowers will be able and willing to meet the repayment terms. Any loan that does not follow this principle should be regarded as an unsound banking practice, regardless of the collateral value and favorable ratio of collateral value to the outstanding loan. While there is no single lending policy appropriate for all branches, there are basic elements that a branch should consider in formulating its policy, including:

- Allocation of funds (i.e., maximum exposure) for real estate lending;
- Definition of acceptable loans that the branch would consider making and the minimum terms that are acceptable to the branch (i.e., amortization rates and cash flow coverage ratio by loan type);
- Geographic area in which the branch will consider lending;
- Minimum standards for credit analysis and loan documentation, including real estate appraisal and evaluation policies;

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- Minimum credit criteria that a borrower must meet for the credit to be considered by the branch;
- Maximum loan amounts and loan maturities that can be extended on a given property type;
- Maximum aggregate loan amounts that may be extended for a given category of real estate loans and for all other real estate loans;
- Required pricing structure for each type of loan;
- Definition of lending authorities and loan approval process;
- Structure and procedures for administrating the disbursement and servicing of the branch's real estate loan portfolio;
- · System for monitoring troubled loans;
- Regular review of procedures and practices to ensure compliance with the branch's lending policy and safe and sound lending practices; and
- Procedures for originating and purchasing loans with loan-to-value ratios in excess of those limits discussed in the Interagency Guidelines for Real Estate Lending Policies, based on the support provided by other credit factors.

REAL ESTATE LENDING ACTIVITY AND RISKS

Real estate lending falls into two broad categories: short-term financing (i.e., construction loans) and permanent financing (e.g., a 30-year residential mortgage or 10-year balloon mortgage on an existing commercial office building). Each type of lending carries with it unique underwriting risks and common risks associated with any type of lending. In all cases, the branch should understand the credit risks and structure of the proposed transaction, even if it is not the originating lender. This policy includes, at a minimum, evaluating the financial strength of the borrower to repay the debt and the value of the underlying real estate collateral.

Permanent financing, as the name implies, is long-term in nature and presents a funding risk because a branch's source of funds is generally of a shorter maturity. Accordingly, branch management should be aware of the source for funding this lending activity. While matching the maturity structures of assets to liabilities is particularly important for a branch's overall loan portfolio management, the importance of

this task is even more evident in real estate lending activity. Many institutions reduce their funding risk by entering into loan participations and sales with other institutions and asset securitization transactions.¹

For a detailed discussion on short-term financing, see the manual section on Real Estate Construction Loans.

UNSOUND LENDING PRACTICES

Some institutions have adversely affected their financial condition and performance by granting loans based on ill-conceived real estate projects. Apart from losses due to unforeseen economic downturns, these losses have generally been the result of poor or lax underwriting standards and improper management of the institution's overall real estate loan portfolio.

A principal indication of an unsound lending practice is an improper relationship between the loan amount and the market value of the property; for example, a high loan-to-value ratio in relation to normal lending practice for a similar type of property. Other unsafe and unsound lending practices include the failure of the institution to examine the borrower's debt service ability, or inappropriate loan structure such as capitalizing interest on a term loan, not requiring principal amortization, or "evergreen" lending—i.e. extending a short-term loan for long-term purposes. For a commercial real estate loan, sound underwriting practices are critical to the detection of problems in the project's plans, such as unrealistic income assumptions, substandard project design, potential construction problems, and a poor marketing plan that will affect the feasibility of the project.

REAL ESTATE LOAN PORTFOLIO CONCENTRATION RISK

A branch should have in place effective internal policies, systems, and controls to monitor and manage its real estate loan portfolio risk. An indication of improper management of a branch's portfolio is an excessive concentration in loans

^{1.} See the section on Asset Securitization for additional information, including information on mortgage-backed securities (MBSs), collateralized mortgage obligations (CMOs), and real estate mortgage investment conduits (REMICS).

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to one borrower or related borrowers, in one type of real estate loan, or in a geographic location outside the branch's designated trade area. In the case of a branch, examiners should base their initial review of asset concentrations on the total assets of the branch. (See the Credit Risk Management section for further information on branch concentrations.)

In identifying loan concentrations, commercial real estate loans and residential real estate loans should be viewed separately when their performance is not subject to similar economic or financial risks. However, groups or classes of real estate loans should be viewed as concentrations when there are significant common characteristics and the loans are affected by similar adverse economic, financial, or business developments. Institutions with asset concentrations should have effective internal policies, systems, and controls in place to monitor and manage this risk

Concentrations that involve excessive or undue risks require close scrutiny by the branch and head office management, and should be reduced over a reasonable period of time. To reduce this risk, the branch should develop a prudent plan and institute strong underwriting standards and loan administration to control the risks associated with new loans.

LOAN ADMINISTRATION AND SERVICING

Real estate loan administration is responsible for certain aspects of loan monitoring. While the administration may be segregated by property type, such as residential or commercial real estate loans, the functions of the servicing department may be divided into the following categories (although the organization will vary among institutions):

Loan closing and disbursement—preparing the legal documents verifying the transaction, recording the appropriate documents in the public land records, and disbursing funds in accordance with the loan agreement.

Payment processing—collecting and applying the loan payments.

Escrow administration—collecting insurance premiums and property taxes from the borrower

and remitting the funds to the insurance company and taxing authority.

Collateral administration—maintaining documents to reflect the status of the branch's lien on the collateral (i.e., mortgage/deed of trust and title policy/attorney's opinion), the value of the collateral (i.e., real estate appraisal or evaluation and verification of senior lien, if in existence), and the protection of the collateral (i.e., hazard/liability insurance and tax payments).

Loan pay-offs—determining the pay-off amount, preparing the borrower release or assumption documents, confirming the receipt of funds, and recording the appropriate lien-release documents in the public land records.

Collections and foreclosure—monitoring the payment performance of the borrower and pursuing collection of past-due amounts in accordance with branch policy on delinquencies.

Claims processing—seeking recoveries on defaulted loans that are covered by a government guarantee or insurance program or a private mortgage insurance company.

The branch should have adequate procedures to ensure segregation of duties for disbursal and receipt of funds control purposes. Additionally, the procedures should address the need for document control because of the importance of the timely recording of the branch's security interests in the public land records.

Some institutions provide various levels of loan services for other institutions, which may range from the distribution of payments received to the ultimate collection of the debt through foreclosure. In such cases, the branch will have the additional responsibility of remitting funds on a timely basis to the other institutions, in accordance with a servicing agreement. The servicing agreement sets forth the servicer's duties, reporting requirements, time frame for remitting funds, and fee structure. If one institution relies upon another institution for servicing, the branch should have adequate control and audit procedures to verify the performance of the servicer (also see the manual section on Asset Securitization). For residential loans sold into the secondary mortgage market for which the branch has retained servicing, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation 3100.1 Real Estate Loans

(FHLMC), and the Government National Mortgage Corporation (GNMA) have specific standards to which the branch (i.e., seller/servicer) must adhere. Failure to meet these standards can result in the termination of the servicing agreement.

ASSESSMENT OF THE BORROWER

While the value of the real estate collateral is an important component of the loan approval process, the branch should not place undue reliance upon the collateral value in lieu of an adequate assessment of the borrower's ability to repay the loan. These assessment factors will differ depending upon the purpose of the loan, such as single family residential loans compared to income producing commercial property loans and commercial or residential development loans (referred to as "commercial real estate lending"). The loan documentation must adequately support the branch's assessment of the borrower and contain the appropriate legal documentation to protect the branch's interests.

Single Family Residential Loans

Some branches make single family residential loans, typically to branch employees. As with other such loans, the branch should evaluate the applicant's creditworthiness and determine whether the individual has the ability to meet monthly mortgage payments and meet all other obligations and expenses associated with home ownership. This process includes an assessment of the applicant's income, liquid assets, employment history, credit history, and existing obligations.2 The branch should also consider the availability of private mortgage insurance, a government guarantee, or a government insurance program, such as loans through the FHAinsured or VA-guaranteed programs, in assessing the credit risk of a loan applicant.

If a branch delegates the loan origination function to a third party, the branch should have adequate controls to ensure that its loan policies and procedures are being followed. The controls should include a review of the third party's qualifications; a written agreement between the branch and the third-party originator to set forth the responsibilities of the third party as an agent for the branch; a periodic review of the third party's operations to ensure that the branch's policies and procedures are being followed; and development of quality controls to ensure that loans originated by the third party meet the branch's lending standards and those of the secondary mortgage market, if the branch expects to sell the mortgages.

Secondary Residential Mortgage Market

In the secondary market, a branch (the primary mortgage originator) sells all or a portion of its interest in residential mortgages to other financial institutions (investors). Thus, the secondary mortgage market provides an avenue for a branch to liquidate a long-term asset, as the need for funds arises. The majority of the secondary mortgage market activity is supported by three government-related or controlled institutions: FNMA,³ FHLMC,⁴ and GNMA ⁵. These entities were created or sponsored by the federal government to encourage the financing and construction of residential housing. FNMA, FHLMC, and GNMA have specific underwriting standards and loan documentation requirements for mortgages, which they purchase or guarantee.

^{2.} There are restrictions on the information that federally-insured branches can request. The Federal Reserve's Regulation B, Equal Credit Opportunity (12 CFR 202), details the information that may and may not be requested on a loan application and provides a model form for a residential mortgage transaction; and Regulation Z, Truth in Lending (12 CFR 226), describes the disclosure requirements to the potential borrower on the cost of financing.

^{3.} Although FNMA was originally created in 1938 as an organization within the federal government, it became a federally chartered, stockholder corporation in 1968, when some of its functions were placed under the newly created GNMA. Financial institutions can either sell mortgages directly to FNMA or pool mortgages for placement in a FNMA-guaranteed mortgage-backed security.

^{4.} FHLMC was sponsored by the Federal Home Loan Bank Board and its members in 1970. Its primary purpose is to provide a secondary market for conventional mortgages originated by thrifts.

^{5.} GNMA, a government agency under the Department of Housing and Urban Development (HUD), was created in 1968 when FNMA became a private corporation. It has several functions to assist in government housing programs, such as managing and liquidating loans acquired by the government. In the secondary market, GNMA acts as a guarantor of mortgage-backed securities for pools of loans originated and securitized by financial institutions.

Generally, financial institutions enter into either a mandatory or a standby commitment agreement with these entities, wherein the financial institution agrees to sell loans according to certain delivery schedules, terms, and performance penalties.

Commercial Real Estate Loans

As with other types of lending activities, the extent of commercial real estate lending activity should be contingent upon the lender's expertise and the branch's experience. In considering an application for a commercial real estate loan, a branch should understand the relationship of the actual borrower to the project being financed. The form of business ownership varies for commercial real estate projects and can affect the financial resources available for the completion of the project and the management and repayment of the loan.

Information on past and current projects constructed, rented, or managed by the potential borrower can help the branch assess the borrower's experience and the likelihood of the proposed project's success. For development and construction projects, the branch should closely review the project's feasibility study. The study should provide sensitivity and risk analyses of the potential impact of changes in key economic variables, such as interest rates, vacancy rates, or operating expenses. The branch should also conduct credit checks of the borrower and of all principals involved in the transaction to verify relationships with contractors, suppliers, and business associates.

Finally, the branch should assess the borrower's financial strength to determine if the principals of the project have the necessary working capital and financial resources to support the project until it reaches stabilization. As with any type of lending on income-producing properties, 6 the branch should quantify the degree of protection from the borrower's (or collateral's) cash flow, the value of the underlying collateral, and any guarantees or other collateral that may be available as a source of loan repayment.

ASSESSMENT OF THE REAL ESTATE COLLATERAL

Branches should obtain an appraisal or evaluation, as required by any applicable federal or state laws or regulations, for all real estate-related financial transactions, before making the final credit or other decision. (Refer to the Real Estate Appraisals and Evaluations part of this section for additional information.) The appraisal section explains the standards for appraisals, indicates which transactions should have an appraisal or an evaluation, provides guidelines on qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches for a Complete Appraisal.

Management is responsible for determining whether the assumptions and conclusions of the appraisal or evaluation are reasonable. In addition, management's rationale for accepting and relying upon the appraisal or evaluation should be documented in writing. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the branch may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation.

Single Family Residential Loans

The assessment of the residential property's market value is critical to the branch's estimate of loan-to-value ratio. This assessment provides the branch with an estimate of the borrower's equity in the property and the branch's potential credit risk, if the borrower should default on the loan. While transactions under \$250,000 may not require an appraisal, a branch is expected to perform an appropriate evaluation of the underlying real estate collateral. Additionally, state laws for appraisals may differ from federal regulatory or internal requirements.

Commercial Real Estate Loans

Due to the variety of uses and the complexity of most commercial projects, there is no uniformly

Income-producing commercial properties include rental apartments, retail properties, office buildings, warehouses, and hotels

accepted format for valuing commercial properties as there is for valuing one-to-four family residential properties. A branch relies upon outside appraisers or, in some instances, in-house expertise to prepare appraisals. For the most part, appraisals on commercial real estate projects are presented in a narrative format with supporting schedules. As the complexity of a commercial project increases, the detail of the appraisal report or evaluation should also increase to fully support the analysis.

When estimating the value of incomeproducing real estate, the appraiser generally relies on the income approach to valuation to a greater degree than on the comparable sales approach or the cost approach. The income approach converts all expected future net operating income into present value terms using different analytical methods. One method, known as the direct capitalization method, estimates the present value of a property by discounting its stabilized net operating income at an appropriate capitalization rate (commonly referred to as a cap rate). Stabilized net operating income is the net cash flow derived from a property when market conditions are stable and no unusual patterns of future rents and occupancy are expected. To approximate stabilized net operating income, the appraiser or branch may need to adjust the current net operating income of a property either up or down to reflect current market conditions. The direct capitalization method is appropriate only for use in valuing stabilized properties.

Another method, known as the discounted cash flow method, requires the discounting of expected future cash flows, at an appropriate discount rate, to determine the net present value of a property. This method is appropriate for use in estimating the values of new properties that have not yet stabilized or for troubled properties that are experiencing fluctuations in income.

The discount rates and cap rates, used in estimating property values, should reflect reasonable expectations about the rate of return that investors and lenders require under normal, orderly, and sustainable market conditions. The appraiser's analysis and assumptions should support the discount and cap rates used in the appraisal. The appraiser should not use exaggerated, imprudent, or unsustainably high or low discount rates, cap rates, or income projections.

In assessing the reasonableness of the facts and assumptions associated with the valuation

of commercial real estate, the branch should consider:

- Current and projected vacancy and absorption rates:
- · Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- The project's feasibility study and market survey to determine support for the assumptions concerning future supply and demand factors:
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property compared to budget projections; and,
- · Discount rates and direct capitalization rates.

Because the income approach is generally relied upon to a greater degree than the other methods, with specific emphasis on arriving at stabilized values, the branch must use judgment in determining the time it will take for a property to achieve stabilized occupancy and rental rates. The analysis of collateral values should not be based on a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions.

The capacity of a property to generate cash flow to service a loan is evaluated on the basis of rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy, rental rates, and net operating income should be based on an analysis of current and reasonably expected market conditions, taking into consideration historical levels, when appropriate.

EARLY INDICATIONS OF TROUBLED COMMERCIAL REAL ESTATE LOANS

Market Related

To evaluate the collectibility of their commercial real estate portfolio, branches should be alert for economic indicators of weakness in their real estate markets and for indicators of actual or potential problems in the individual commercial real estate projects. Available indicators, which may be useful in evaluating the

condition of the local real estate market, include permits for and the value of new construction, absorption rates, employment trends, vacancy rates, and tenant lease incentives. Weaknesses disclosed by these types of statistics may signify that a real estate market is experiencing difficulties that may cause cash flow problems for individual real estate projects, declining real estate values and ultimately, troubled real estate loans.

Project Related

Characteristics of potential or actual difficulties in commercial real estate projects may include:

- An excess supply of similar projects under construction in the same trade area;
- The lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions;
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions):
- Rent concessions or sales discounts, resulting in cash flow below the level projected in the original feasibility study, appraisal or evaluation:
- Concessions on finishing tenant space, moving expenses, and lease buyouts;
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan:
- Delinquent lease payments from major tenants;
- Land values that assume future rezoning;
- · Tax arrearages; and,
- Environmental hazards and liability for cleanup.

As the problems associated with a commercial real estate loan become more pronounced, the borrower/guarantor may experience a reduction in cash flow to service related debts, which could result in delinquent interest and principal payments.

While some real estate loans become troubled because of a general downturn in the market, others become troubled because the loans were originated on an unsound or a liberal basis. Common examples of unsound loans include:

· Loans with little or no borrower equity;

 Loans on speculative, undeveloped property where the borrower's only source of repayment is the sale of the developed property;

- Loans based on land values that have been driven up by rapid turnover of ownership but without any corresponding improvements to the property or supportable income projections to justify an increase in value;
- Additional advances to service an existing loan without evidence that the loan will be repaid in full;
- Loans to borrowers with no development plans or noncurrent development plans;
- Renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule⁷;
- Evergreen loans—short-term, interest-only loans that are renewed annually with no provision for repayment. Although structured as a short-term loan, these loans are intended for long-term purposes such as for the acquisition or development of real estate;
- Loans that continue to capitalize interest after construction is completed because of slower than anticipated lease-up;
- Loans with no meaningful principal amortization, instead relying on price appreciation and the sale of property for repayment; and,
- Loans that are funded before zoning is obtained, water rights acquired, or an environmental study is performed.

EXAMINER REVIEW OF COLLATERAL VALUE

The focus of an examiner's review of a real estate loan is on the ability of the loan to be repaid. The principal factors that bear on this review are the income-producing potential of the underlying collateral and the borrower's willingness and ability to repay the loan from other resources, if necessary, and according to existing loan terms. In evaluating the overall risk associated with a real estate loan, examiners should consider a number of factors, including

^{7.} As discussed more fully in the section on Asset Quality Classifications, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

the borrower's character, overall financial condition and resources, and payment history; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.8 As the borrower's and guarantor's ability to repay a troubled real estate loan decreases, the importance of the collateral value of the loan increases commensurately.

An examiner's analysis of the collateral value is based on the branch's most recent appraisal or evaluation and includes a review of the major facts, assumptions and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal or evaluation.

Examiners should not make adjustments to appraisal or evaluation assumptions for credit analysis purposes based on worst-case scenarios that are unlikely to occur. For example, examiners should not necessarily assume that a building will become vacant just because an existing tenant, who is renting at a rate above today's market rate, may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

Assumptions should be given a reasonable amount of deference when recently made by qualified appraisers or qualified evaluators and when consistent with the discussion above. Examiners should not challenge the underlying assumptions, including discount rates and cap rates used in appraisals or evaluations, that differ only in a limited way from norms that would generally be associated with the property under review. However, the estimated value of the underlying collateral may be adjusted for

credit analysis purposes when the examiner can establish that underlying facts or assumptionsare inappropriate and can support alternative assumptions.

CLASSIFICATION GUIDELINES

As with other types of loans, real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. In analyzing loans, the examiner should focus on the ability of the borrower, guarantor, or the collateral to provide the necessary cash flow to adequately service the loan. However, the fact that the underlying collateral value equals or exceeds the current loan balance, does not preclude the loan from classification if other factors jeopardize the repayment ability of the borrower, such as the lack of credible financial support for full repayment from reliable sources.

Similarly, loans to sound borrowers that are refinanced or renewed according to prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or categorized as special mention, unless well-defined weaknesses exist that jeopardize repayment. A branch should not be criticized for working with borrowers whose loans are classified or categorized as special mention, as long as the branch has a well-conceived and effective workout plan for such borrowers and effective internal controls to manage the level of these loans.

In evaluating real estate credits for possible classification, examiners should apply the standard classification definitions as set forth in the Classification of Credits section of the manual. In determining the appropriate classification, examiners should consider all important information regarding repayment prospects, including information on the borrower's creditworthiness, the value of and cash flow provided by all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's performance history to date is important and must be considered by the examiner. As a general principle, a performing real estate loan should not be automatically classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a

^{8.} The primary basis for the review and classification of the loan should be the original source of repayment and the borrower's intent and ability to fulfill the obligation without relying on third-party guarantees. However, examiners should also consider the support provided by any guarantees when determining the appropriate classification treatment for a troubled loan. The treatment of guarantees in the classification process is discussed in the Asset Quality Classifications section of this manual.

performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.⁹

These classification guidelines apply to individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sectors.

Troubled Project-Dependent Commercial Real Estate Loans

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral and there are no other available and reliable sources of repayment. As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral and that can be clearly identified as uncollectible, should be classified "loss." The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than substandard. The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified doubtful when the potential for full loss may be mitigated by the outcome of certain pending events or when loss is expected, but the amount of the loss cannot be reasonably determined. If warranted by the underlying circumstances, an examiner may use a doubtful classification on the entire loan balance. However, this methodology would occur infrequently.

Partially Charged-Off Loans

An evaluation based upon consideration of all relevant factors may indicate that a credit has well-defined weaknesses that jeopardize collection in full, although a portion of the loan may be reasonably certain of collection. When a charge-off has been taken in an amount sufficient to ensure that the remaining recorded balance of the loan (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when welldefined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than substandard.

A more severe classification than substandard for the remaining recorded balance would be appropriate, however, if the loss exposure cannot be reasonably determined; for example, where significant risk exposures are perceived, such as in the case of bankruptcy situations or loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance more severely than substandard would be appropriate when sources of repayment are considered unreliable.

Formally Restructured Loans

The classification treatment previously discussed for a partially charged-off loan would also generally be appropriate for a formally restructured loan, when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms.¹⁰ Troubled commercial real estate loans, whose terms have been restructured, should be identified in the institution's

^{9.} Another issue that arises in the review of commercial real estate loans is its accrual or nonaccrual treatment for reporting purposes. The federal banking agencies, under the auspices of the FFIEC, have provided guidance on nonaccrual status in the instructions for the Report of Assets and Liabilities (call report) and in related supervisory guidance of the banking regulatory agencies. This guidance is summarized in the Credit Risk Management section of this manual.

^{10.} An example of a restructured commercial real estate loan that does not have reasonable modified terms would be a "cash flow" mortgage, which requires interest payments only when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

internal credit review system and closely monitored by management.

REAL ESTATE APPRAISALS AND EVALUATIONS

Bank regulators have a long-standing policy on real estate appraisals that emphasizes the importance of sound appraisal policies and procedures. In December 1987, the federal banking agencies jointly adopted supervisory guidelines for real estate appraisal policies and review procedures (which were revised in September 1992). With the passage of Title XI of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989, in August 1990, the federal banking agencies adopted regulations regarding the performance and utilization of appraisals by federally regulated financial institutions.

The intent of Title XI of FIRREA is to protect federal financial and public policy interests in real estate-related financial transactions requiring the services of an appraiser. Title XI requires that real estate appraisals be performed in writing in accordance with uniform standards and by individuals with demonstrated competency and whose professional conduct is subject to effective supervision. In this regard, Title XI required each state to establish a program for certifying and licensing real estate appraisers, who are qualified to perform appraisals in connection with federally-related transactions (which are defined later in this section). Additionally, Title XI designated the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. However, Title XI left to the states the authority to establish qualification standards for licensing. Title XI established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council to monitor the requirements established to meet the intent of Title XI.

Applicability of Title XI of FIRREA to Branches

The requirements of the appraisal regulations adopted by each of the federal banking agencies

pursuant to Title XI of FIRREA are discussed in the remainder of this section. The appraisal regulations are directly applicable only to FDIC-insured branches. In uninsured branches, examiners may use the regulations as general supervisory guidance when reviewing appraisal practices. As such, while an examiner in an uninsured branch may not cite the branch as being in violation of law or regulation for appraisal practices not consistent with the standards set forth in Title XI and the implementing appraisal regulations, the examiner may criticize such practices in the report of examination if considered appropriate from a risk management basis.

Effective Date

Appraisals performed in connection with federally-related transactions after the effective date of August 9, 1990, are to comply with the regulations. Appraisals for real estate-related financial transactions entered into before August 9, 1990, do not have to comply with the regulations. However, the branch would have had to adhere to the Federal Reserve Board's supervisory guidelines, issued in 1987, for such real estate appraisals. Transactions are deemed to have been entered into and a loan is deemed to have been originated if there was a binding commitment to perform, before the effective date.

The requirement to use a state-certified or -licensed appraiser had a separate effective date of no later than December 31, 1992. However, states had the flexibility to adopt an earlier implementation date regarding state requirements that an appraiser be certified or licensed to perform an appraisal within their state. Financial institutions doing business in a state that had an effective date for mandatory use of certified or licensed appraiser earlier than the federally-mandated effective date would have had to abide by any state laws in this regard.

Branch Appraisal and Evaluation Policy

Branch and head office management is responsible for adopting policies and procedures that

establish effective real estate appraisal and evaluation programs for the branch. Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of appraisals and evaluations to fully assess credit risk. While the appraisal plays an important role in the loan approval process, undue reliance should not be placed upon the collateral value in lieu of an adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important that branches have sound appraisal policies and procedures as a method of controlling risk.

Appraisal and Evaluation Programs

The appraisal and evaluation programs of a branch should be tailored to the branch's size, location, and the nature of its real estate market and attendant real estate-related activity. Such programs should establish prudent standards and procedures that ensure written appraisals or evaluations are obtained and analyzed for real estate-related financial transactions before the branch makes its final credit decision.

The branch's appraisal and evaluation programs should also establish the manner in which it selects, evaluates, and monitors individuals who perform real estate appraisals or evaluations. The key elements of the branch's programs should ensure that individuals possess the requisite expertise to satisfactorily complete the assignment, hold the proper state certification or license, if applicable, and are capable of rendering a high quality, written appraisal or evaluation.

Compliance Procedures

To ensure the branch's compliance with applicable supervisory guidelines, the branch should have established regulatory compliance procedures for all appraisals and evaluations. Additionally, a branch should critique selected appraisals and evaluations for adequacy and relevance of the data before making final credit decisions. The critique should consider the appropriateness of the methods and approaches used, and assess the reasonableness of the analy-

ses, opinions, and conclusions. The branch should maintain formal documentation or evidence of the critique to support the compliance review. An individual performing critiques, either an employee of the branch or an outside consultant, should have real estate-related training or experience and be independent of the transaction. The individual may not change the estimate of value of the appraisal or evaluation as a result of a critique.

Reappraisals and Reevaluations

The program should also include a process for determining when a reappraisal and reevaluation is required on a prior transaction. In these situations, the original appraisal or evaluation will have become unreliable, e.g., the useful life of the appraisal or evaluation has ended and further circumstances dictate that the collateral should be reappraised or reevaluated. The individual who makes this determination should have real estate-related training or experience.

The decision to obtain a reappraisal or reevaluation will depend upon the condition and quality of a credit or investment and the soundness of the underlying collateral. The volatility of the local real estate market should also be considered in determining the need for a reappraisal or reevaluation. In certain situations, such as loan workouts, loan renewals, loan restructurings, or problem credits or investments, the need for a reappraisal or reevaluation should receive particularly close attention. In all cases, the information sources and analyses relied upon must sufficiently support a branch's determination of whether a reappraisal or reevaluation is required. Reappraisals should conform with appraisal regulations, and reevaluations should conform with applicable supervisory guidelines.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit, including acceptances of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

FEDERALLY-RELATED FINANCIAL TRANSACTIONS

A federally-related transaction is defined in Title XI as a real estate-related financial transaction that a federal financial institution's regulatory agency engages in, contracts for, or regulates and that requires the services of an appraiser. Title XI further defines a real estate-related financial transaction as any transaction involving the sale, lease, purchase, investmentin, or exchange of real property, including interests in property or the financing thereof; the refinancing of real property or interests in real property; or the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

The federal banking agencies recognize that not all real estate-related financial transactions require the services of a certified or licensed appraiser and, therefore, would not be considered federally-related transactions. While these transactions do not require a certified or licensed appraisal, an evaluation of the underlying collateral is required under existing supervisory guidelines.

Transaction Value

The transaction value is defined as the amount of the loan or extension of credit under consideration. For a pool of loans or a mortgage-backed security, the transaction value is the amount of each individual loan. In determining transaction value, the senior and junior debt are considered separate transactions under the appraisal rule. However, a series of related transactions will be considered one transaction if it seems that an institution is attempting to avoid the appraisal requirement by structuring the transactions below the appraisal threshold.

Transactions Not Requiring the Services of a Licensed or Certified Appraiser

Currently, the categories of transactions not requiring the services of an appraiser include transactions where:

- The transaction value is \$250,000 or less;
- · A lien on real property has been taken as

collateral, solely through an abundance of caution and, as a consequence, the terms of the transaction have not been made more favorable than the terms would have been in the absence of a lien;

- The transaction is not secured by real estate;
- A lien on real estate has been taken for purposes other than the real estate's value;
- The transaction is a business loan that has a transaction value of \$1 million or less and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
- A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
- The transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met the Board's regulatory requirements for appraisals at the time of origination;
- The transaction is wholly or partially insured or guaranteed by a U.S. government agency or U.S. government- sponsored agency;
- The transaction either qualifies for sale to a U.S. government agency or U.S. governmentsponsored agency, or involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate; or
- There is a subsequent transaction resulting from a maturing extension of credit, provided that:
 - The borrower has performed satisfactorily, according to the original terms;
 - No new monies have been advanced, other than as previously agreed;
 - The credit standing of the borrower has not deteriorated; and
 - There has been no obvious and material deterioration in market conditions or physical aspects of the property, which would threaten the branch's collateral protection; or
 - A branch purchases a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, provided that the appraisal prepared for each pooled loan or real property

interest met the requirements of the appraisal regulation.

When a real estate-related financial transaction does not require a certified or licensed appraiser, the U.S. regulator may still require an appropriate evaluation of the real property that is consistent with the guidelines for real estate appraisal and evaluation programs.

Obtaining an Appraisal

The branch or its agent is responsible for engaging the appraiser and must have sufficient time to analyze the appraisal as part of the decision process to enter into the transaction. A branch may not accept an appraisal prepared for a potential borrower as the appraisal for a federally related transaction. However, an appraisal prepared for one federally-regulated financial institution may be used by the branch, so long as the branch has established procedures for reviewing appraisals, the review indicates that the appraisal meets the regulation, and the review is documented in writing.

When to Obtain an Appraisal

The branch should obtain the appraisal in sufficient time to be analyzed before the branch makes its final credit or other decision. In certain circumstances, when a branch acts to prudently protect its interest by modifying the terms and conditions of an existing extension of credit to facilitate orderly collection and thereby reduce its risk of loss, an appraisal or evaluation may be obtained after the branch makes its decision concerning the extension of credit.

The determination of when a federally-related transaction has occurred may be difficult to define in existing credits or in established lending arrangements. A new federally-related transaction is generally considered to have occurred when there is a potential change in the branch's exposure to risk. This includes, but is not limited to the following situations.

Phased Developments—The appraisal of an earlier phase cannot be used for a new phase. However, if the original appraisal was prepared for all phases of the project, the branch may use the project appraisal, provided that the appraisal is still valid at the time the branch extends the additional credit for the new phase.

Cross-Collateralization—In cases where multiple loans are secured by separate parcels of real estate and are collateralized by the real estate pledged to other loans, the branch would not necessarily be required to reappraise all real estate collateral if an extension or renewal is granted on one of the loans. However, if the branch is relying on the excess collateral of the other loans to support the loan in question, the branch would have to have a valid appraisal on all real estate collateral.

Loan Assumptions—If a new borrower is substituted for the original borrower and the original borrower is released from any future obligation on the loan, the branch would be required to have a valid appraisal.

Loan Restructuring and Workouts—A branch would have to have a valid appraisal if the transaction is a refinancing.

Foreclosures—At the time title to foreclosed real estate passes to the branch, a branch needs to have a valid appraisal. It is recommended that the individual who performed the appraisal for the original credit decision should normally not perform the appraisal for this subsequent transaction.

Sale of Other Real Estate Owned (OREO)—A branch is required to have a valid appraisal when the sale occurs. The appraisal prepared for the foreclosure may be used, if that appraisal remains valid.

Useful Life of Appraisals or Evaluations

The useful life of an appraisal or evaluation will vary depending upon the circumstances surrounding the property and the marketplace. When deciding if an appraisal or evaluation may be used for a subsequent transaction, a branch should determine if there has been any material change to the underlying assumptions, which would affect the original estimate of value.

Examples of factors that could cause material changes to reported values include the passage of time; the volatility of the local market; the

availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject or competing, surrounding properties; change in zoning; or environmental contamination. The branch should document its information sources and analyses used to determine that an existing appraisal or evaluation remains valid and that the branch will use that appraisal or evaluation in a subsequent transaction

Updated Appraisal

An updated appraisal is currently not acceptable as an appraisal under the Board of Governors' regulation. However, a branch may use an updated appraisal in the following cases:

- To evaluate real estate when a federallyrelated transaction has not occurred; or
- To assess the useful life of an appraisal.

APPRAISAL REQUIREMENTS

The objective of an appraisal is to communicate the appraiser's reasoning and conclusions in a logical manner so that the reader is led to the appraiser's estimation of market value. The contents of appraisals should conform to the standards of the Board's appraisal regulation, if applicable, and the Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by the Appraisal Standards Board of the Appraisal Foundation. The actual form, length, and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Standard forms completed in compliance with the rule and USPAP are also acceptable.

Appraisal Options

A branch may engage an appraiser to perform either a Complete or Limited Appraisal. When performing a Complete Appraisal assignment, an appraisal must comply with all USPAP standards without departing from any binding requirements and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the

Departure Provision which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches to value. Departure from standards designed as binding requirements is not permitted.

A branch and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the branch or agency or other intended users of the appraisal report. The banking regulators do not prohibit the use of a Limited Appraisal for a federally related transaction, but the bank regulators believe that branches should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulized report with the supporting details maintained in the appraiser's files.

The banking agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of a branch's real estate transactions and under other circumstances when a branch's program requires an evaluation.

Moreover, since a branch is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The branch's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written

engagement letter that outlines the branch's expectations and delineated each party's responsibilities, especially for large, complex, or out-of-area properties.

Appraisal Standards

Title XI mandated that the minimum standards for Complete appraisals performed in connection with federally-related transactions are standards set forth in USPAP together with any other standards that the federal banking agencies deem necessary. In summary, an appraisal must:

- Be performed by a qualified, independent staff
 or fee-paid appraiser, selected by the branch,
 who is competent and knowledgeable of relevant markets. The appraiser must also hold
 the proper state certification or license as
 required under the appraisal regulations. An
 independent appraisal is one in which the
 appraiser is not participating in the administration of the credit or in the approval of the
 transaction and has no interest, financial or
 otherwise, in the property;
- Result in a market value that is defined as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, assuming the buyer and seller are both acting prudently and knowledgeably and the price is not affected by any undue stimulus;
- State the market value in terms of the cash equivalent value, which reflects the value of the property without the influence of special or creative financing or seller concessions;
- Follow a reasonable valuation method, which addresses cost, income, and direct sales comparison approaches to determine market value, unless the appraiser fully explains and documents the elimination of an approach;
- Support the current valuation of the real estate. All assumptions and projections should be supportable by current market conditions and expectations of current market trends. In the case of income property, the capitalization rate, discount rate, net income and/or loss projections, cash flow, financing terms, and absorption rate should be reasonable and supportable by current market conditions;
- Document and explain how the discount and capitalization rates used in generating present value estimates were derived;

- Render the "as is" value, which reflects the value of the property in its current physical condition and subject to the zoning in effect as of the appraisal date. Appropriate deductions and discounts should be made for proposed development projects to reflect holding costs, marketing expenses, and entrepreneurial profit, which are based on stabilized occupancy for commercial projects or a retail sales program for residential projects;
- Report the sales history on the appraised property for one year for 1-to-4 family residential properties and three years for all other types of properties;
- Address a proposed project's marketability and feasibility prospects. Studies prepared by a party other than the appraiser must be verified to the extent assumptions are utilized. The appraiser's acceptance or rejection of the third party study and its impact on value must be fully explained;
- State the marketing period for the appraised property, the effective date of the appraisal, and the date the appraisal was rendered;
- Include a legal description of the subject property;
- Identify and separately value any personal property, fixtures, and intangible items that are not real property but are included in the appraisal, and discuss the impact of their inclusion or exclusion on the estimate of market value of the real property;
- Contain an appraiser's certification statement in which the appraiser attests to the accuracy of the data, the disclosure of assumptions, and independence from the transaction; states whether an inspection of the property was made; discloses any professional assistance received from another appraiser; and certifies that a fee, contingent on the value rendered, was not received; and
- The appraisal regulations and USPAP provide a complete listing of the appraisal standards.

Appraisal Valuation Approaches

There are three basic approaches used in appraising the market value of real estate in a Complete Appraisal:

- Cost Approach;
- Market Data or Direct Comparable Sales Approach; and
- Capitalization of Income Approach.

All three approaches have particular merits depending upon the type of real estate being appraised. For single family residential property, the cost and comparable sales approaches are most frequently used because the common use of the property is the personal residence of the owner. However, if a single family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach and the cost and comparable sales approaches. For special use commercial properties, the appraiser may have difficulty in obtaining sales data on comparable properties and may have to base the value estimate on the cost and capitalization of income approach. If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this affects the value estimate.

Value Correlation

The three value estimates—cost, market, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. Where these value estimates are relatively close together, correlating them and setting the final market value estimate presents no special problem. It is in situations where widely divergent values are obtained by using the three appraisal approaches that judgment must be exercised in analyzing the results and determining the estimate of market value.

Cost Approach

In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any depreciation, i.e., disadvantages or deficiencies of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as

though vacant; (2) estimate the current cost of reproducing the existing improvements; (3) estimate depreciation and deduct from the reproduction cost estimate; and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

Market Data or Direct Sales Comparison Approach

The essence of this approach is to determine the price at which similar properties have sold for recently on the local market. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. The market approach to value estimation is essential in nearly every appraisal of real property and is based on the following assumptions:

- Market value is the highest price for which a property is deemed most likely to sell in a competitive market;
- A reasonable time is allowed for exposure of the property in the open market;
- Payment is to be made in cash or on terms reasonably equivalent to cash or on typical financing terms available at the time of the appraisal;
- Both the buyer and seller are typically motivated and the price is not affected by undue stimulus; and
- Both buyer and seller act prudently and knowledgeably and have reasonable knowledge of the various uses to which the property may be put.

The application of this approach produces an estimate of value of a property by comparing it with similar properties that have been sold recently. The process used in determining the degree of comparability of two or more properties involves judgment as to their similarity with respect to age, location, condition, construction, layout, and equipment. The sales price or list price of those properties deemed most comparable tend to set the range in which the value of the subject property lies.

Capitalization of Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach typically is used to determine the market value of income producing properties, such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted cash flow techniques to arrive at a market value. These techniques include band-of-investments method, mortgage equity method, annuity method, and land residual technique. The use of a particular technique will depend upon whether there is project financing, whether there are long-term leases with fixed level payments and whether the value is being rendered for a component of the project, such as land or buildings.

The accuracy of this method depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and method. The following data are assembled and analyzed to determine potential net income and value:

- Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This information provides gross rental data and the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce;
- Expense data, such as taxes, insurance, and operating costs being paid from revenues derived from the subject property and by comparable properties. Historical trends in these expense items are also determined;
- Time frame for achieving a "stabilized" or normal occupancy and rent levels (also referred to as holding period); and
- An appropriate capitalization rate and valuation technique are selected and applied to net income to establish a value estimate.

Basically, the income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is used to value income proper-

ties. This method calculates the value of a property by dividing an estimate of its "stabilized" annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The "cap" rate—usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated in terms of current income.

The use of this technique assumes that either the stabilized income or the "cap" rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

For special use properties, new projects, or troubled properties, the discounted cash flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a time frame for achieving a "stabilized," or normal occupancy and rent level, is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be based on the ability of the project to generate income over time based upon reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions. For further discussion, refer to the section of this manual on Real Estate Loans.

Other Definitions of Value

An appraisal for a federally-related transaction must reflect a market value as defined in the

regulations. The regulations also require that, for development projects, the appraisal contain the "as is" value as of the date of the appraisal. However, there are other definitions of value that are encountered in appraising and evaluating real estate transactions. These include:

Fair Value. This term is an accounting term that is generally defined as the amount, in cash or cash equivalent value or other consideration, that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (i.e., selling price), that is, other than in a forced or liquidation sale. According to accounting literature, fair value is generally used in valuing assets in troubled debt restructuring, quasireorganizations, nonmonetary transactions, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.

Investment Value. This term is based on the data and assumptions that meet the criteria and objectives of a particular investor for a specific property or project. The investor's criteria and objectives are often substantially different than participants in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit analysis decisions.

Liquidation Value. This term assumes that there is little or no current demand for the property and that the property needs to be disposed of quickly, resulting in the owner sacrificing potential property appreciation for an immediate sale.

Going-Concern Value. This term is based on the value of a business entity rather than the value of just the real estate. The valuation is based on the existing operations of the business that has a proven operating record with the assumption that the business will continue to operate.

Assessed Value. This term represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.

Net Realizable Value (NRV). This term is recognized under generally accepted accounting prin-

ciples (GAAP) as "the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal." The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price are generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

The appraiser should state the definition of value reported in the appraisal, and, for federally-related transactions, the value must meet the market value definition as defined in the regulations. This value is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, assuming the buyer and seller are both acting prudently and knowledgeably and the price is not affected by undue stimulus. Other presentations of value, in addition to market value, are allowed and may be included in the appraisal at the request of the branch.

EVALUATION REQUIREMENTS

The appraisal regulations identify certain real estate-related financial transactions that do not require the services of an appraiser (i.e., do not need an appraisal). In the context of Title XI of FIRREA, an appraisal means the kind of specialized opinion as to the value of real estate containing certain formal elements recognized by appraisal industry practices and standards. For transactions that do not require an appraisal by a licensed or certified appraiser under the appraisal regulations, the branch should establish an evaluation program and perform an appropriate evaluation of the real estate for these transactions as a prudent banking practice. The evaluation should result in a determination of value that will assist the branch in assessing the soundness of the transaction and that will protect the branch's interest in the transaction. Further, the evaluation need not meet all of the detailed requirements of an appraisal as set forth in the appraisal regulations.

Bank regulators' appraisal regulations allow an institution to use an appropriate evaluation of

real estate rather than an appraisal when the transaction:

- Has a value of \$250,000 or less;
- Is a business loan of \$1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or
- Involves an existing extension of credit at the lending branch, provided that: (i) there has been no obvious and material change in the market conditions or physical aspects of the property that threaten the adequacy of the branch's real estate collateral protection after the transaction, even with the advancement of new monies; or (ii) there is no advancement of new monies other than funds necessary to cover reasonable closing costs.

The branch is not precluded from obtaining an appraisal that conforms to the regulation for any real estate-related financial transaction. If a branch makes loans that may be sold into the secondary market at a later date, the branch may need to ensure that they meet the secondary mortgage market requirements.

Form and Content of Evaluations

The documentation for evaluations should fully support the estimate of value and include sufficient information to understand the evaluator's analysis and assumptions. There is no requirement that the evaluator use a particular form or valuation approach but the analysis should be applicable to the type of property and fully explain the value rendered.

An evaluation, at a minimum, should:

- Be written;
- Include the preparer's name, address, and signature, and the effective date of the evaluation;
- Describe the real estate collateral, its condition, its current and projected use;
- Describe the source(s) of information used in the analysis;
- Describe the analysis and supporting information; and
- Provide an estimate of the real estate's market value, with any limiting conditions.

An individual who conducts an evaluation should have real estate-related training or experience relevant to the type of property but does not have to be a state-licensed or -certified appraiser. Prudent practices generally require that, as the branch's exposure in a real estaterelated financial transaction increases, a more detailed evaluation should be performed, whether or not specifically subject to appraisal regulations.

An evaluation for a transaction that needs a more detailed analysis should fully describe the property and discuss its use, especially for nonresidential property. An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An evaluation for a transaction that requires a less detailed analysis may be based upon information, such as comparable property sales information from sales data services, for example, the multiple listing service or current tax assessed value in appropriate situations. Further, the branch's own real estate loan portfolio experience and value estimates, which were prepared for recent loans on comparable properties where appraisals meeting the requirements of the regulation were obtained, may be used. Regardless of the method, the branch must document its analysis and findings in the loan file.

Letter Updates

A branch may use letter updates to an appraisal as an evaluation even though such updates do not conform to the appraisal regulations and would not be acceptable for the initial credit decision for federally-related transactions. For example, an existing appraisal for a first mortgage might be updated for a subsequent home equity line of credit where the extension of credit is below the threshold amount.

QUALIFICATIONS CRITERIA FOR APPRAISERS AND EVALUATORS

The accuracy of an appraisal or evaluation depends on the competence and integrity of the

individual performing the appraisal or evaluation and the expertise of the appraiser or evaluator at developing and interpreting pertinent data for the subject property. Appraisers and evaluators should have adequate training, experience, and knowledge of the local real estate market to make sound judgments concerning the value of a particular property. The level of training, experience, and knowledge should be commensurate with the type and complexity of the property to be valued. Additionally, appraisers and evaluators should be independent of the credit decision, have no interest in the property being appraised, and have no affiliations or associations with the potential borrower.

Appraiser Qualifications

Under Title XI of FIRREA, two classifications of appraisers were identified to be used in federally-related transactions: "state-certified appraiser" and "state-licensed appraiser." For a certified appraiser, Title XI contemplated that the states would adopt similar standards for certification based on the qualification criteria of the Appraiser Qualifications Board of the Appraisal Foundation. These standards set forth minimum educational, testing, experience, and continuing education requirements. For a licensed appraiser, the states have some latitude in establishing qualification standards provided that the criteria are adequate to protect federal financial and public policy interests.

The Appraisal Subcommittee of the FFIEC is responsible for monitoring the states for compliance with Title XI. The federal banking agencies also have the authority to impose additional certification and licensing requirements to those adopted by a given state.

Selection of an Appraiser

In selecting an appraiser for an appraisal assignment, a branch is expected to consider whether the individual holds the proper state certification or license and has the appropriate experience and educational background to complete the assignment. Financial institutions may not exclude a qualified appraiser from consideration for an appraisal assignment solely because the appraiser lacks membership in a particular appraisal organization or does not hold a par-

ticular designation from an appraisal association, organization, or society.

In that regard, branches should treat all appraisers fairly and equitably in determining whether to use the services of a particular appraiser. Generally, financial institutions have established procedures for selecting appraisers and maintaining an approved appraiser list. The practice of pre-approving appraisers for on-going appraisal work and maintaining an approved appraiser list is acceptable as long as all appraisers are required to follow the same approval process. However, a branch that requires appraisers who are not members of a particular appraisal organization to formally apply, pay an application fee, and submit samples of previous appraisal reports for review—but does not have identical requirements for appraisers who are members of certain appraisal organizations would be viewed as having a questionable selection process.

APPRAISALS PERFORMED BY CERTIFIED OR LICENSED APPRAISERS

In summary, a federally-insured branch is required to use a Certified Appraiser for:

- All federally-related transactions over \$1 million:
- Nonresidential federally-related transactions of \$250,000 or more; and
- Complex residential federally-related transactions of \$250,000 or more.

A federally-insured branch is required to use a Licensed Appraiser for:

 All other federally-related transactions over the \$250,000 transaction value not requiring the services of a certified appraiser. These also may be performed by a certified appraiser.

Some of the states have adopted other appraiser designations, which may cause confusion on whether a particular appraiser holds the appropriate designation for a given appraisal assignment. Additionally, some states have used designations such as "certified residential" appraiser and "certified general" appraiser, which leads to further confusion. Other states have no specified license designation but have

used the term "certified residential" based on the standards for licensing. For this reason, the branch needs to understand (1) the qualifications criteria set forth by the state appraiser regulatory body and (2) whether these standards are equivalent to the federal designations as accepted by the Appraisal Subcommittee.

Other Appraiser Designations

The Appraisal Subcommittee recognized two other appraiser designations: certified residential appraiser and transitional license. For the certified residential appraiser, the minimum qualification standards are those established by the Appraiser Qualifications Board for "certified residential real estate appraiser." Under the appraisal regulations, a certified residential appraiser would be permitted to appraise real estate in connection with a federally-related transaction designated for a "certified" appraiser as long as the individual is competent for the particular appraisal assignment.

The Appraisal Subcommittee and the federal banking agencies also recognized a transitional license, which allowed a state to issue a license to an appraiser provided that the individual had passed an examination and had satisfied either the education or experience requirement. A transitional licensed appraiser was permitted to appraise real estate collateral in connection with a federally-related transaction as if licensed. The transitionally-licensed appraiser was expected to complete the missing requirement within a set time frame or the license would expire. The recognition of a transitional license was believed to be necessary to ease the initial problems and inefficiencies resulting from the establishment of a new regulatory program. The Appraisal Subcommittee advised the states that the use of the transitional license should be phased out over time once the appraiser regulatory program is fully established. As a result, the use of the transitional license and the applicable time frame varies from state to state.

Qualifications of Individuals Who Can Perform Evaluations

Evaluations can be performed by a competent person who has experience in real estate-related activities, including but not limited to appraisals, real estate lending experience, real estate consulting, and real estate sales. An individual performing an evaluation need not be licensed or certified. The branch's evaluation procedures should have established standards for selecting qualified individuals to perform evaluations and confirming their qualifications and independence to perform an evaluation for a particular transaction.

Supervisory Policy and Evaluations

A branch's appraisal and evaluation policies and procedures should be reviewed as part of the examination of its overall real estate-related activities to ensure compliance with regulations, if a federally-insured branch, and to evaluate risk management techniques as appropriate. This process would include a review of the procedures for selecting an appraiser for a particular appraisal assignment and confirming that the appraiser is qualified, independent, and licensed/ certified to undertake the assignment. If a branch maintains a list of qualified real estate appraisers acceptable for the branch's use, the examiner should ascertain whether senior management of the branch has periodically reviewed and approved the list.

When analyzing individual credits, examiners should analyze appraisals or evaluations to determine that the methods, assumptions, findings, and conclusions are reasonable and in compliance with any applicable appraisal regulations and supervisory guidelines. Examiners should not challenge the underlying assumptions, including discount rates and capitalization rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. Additionally, an examiner is not bound to accept the results of the appraisal or evaluation, regardless of whether a new appraisal or evaluation was requested during the examination. If an examiner concludes that an appraisal or evaluation is deficient for any reason, that fact will be taken into account in reaching a judgment on the quality of the credit.

When the examiner can establish that the underlying facts or assumptions are inappropriate and can support alternative assumptions, the examiner may adjust the estimated value of the property for credit analysis purposes. It is

important to emphasize that an examiner's overall analysis and classification of a credit may be based upon other credit or underwriting standards, even if the loan is secured by real property whose value is supported by an appraisal or evaluation. Further discussion on the examiner's assessment of value for loan classification can be found in sections in this manual on Classification of Credits.

Significant failures to meet applicable standards and procedures as outlined previously should be criticized and corrective action should be required. Furthermore, inadequate appraisal and evaluation procedures may be considered an unsafe and unsound banking practice if the failure to accurately reflect the value of assets on a timely basis misrepresents the branch's financial condition. In this situation, formal corrective measures will be pursued as appropriate.

The appraisal regulation and guidelines require that federally-insured financial institutions use the services of qualified, independent, certified or licensed appraisers to perform appraisals. A branch that knowingly uses the services of an individual to perform an appraisal in connection with a federally-related transaction who is not properly certified or licensed is in violation of Section 1120(a)(1) of Title XI of FIRREA. Any action of a state-certified or -licensed appraiser that is contrary to the purpose of Title XI should be reported to the branch's appropriate federal and/or state regulators for referral to the state appraiser regulatory agency for investigation.

ENVIRONMENTAL LIABILITY

In connection with any real estate lending activity, a branch and its legal entity, the foreign banking organization, may be subject to liability associated with the clean-up of hazardous substance contamination pursuant to the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), the federal superfund statute. CERCLA was enacted in response to the growing problem of improper handling and disposal of hazardous substances. CERCLA authorizes the Environmental Protection Agency (EPA) to clean up hazardous waste sites and to recover costs associated with the clean up from entities specified in the statute. The superfund statute is the primary federal law dealing with hazardous substance contamination. However, there are numerous other federal

and state statutes that establish environmental liability that could place banking organizations at risk. For example, underground storage tanks are also covered by separate federal legislation.¹¹

While the superfund statute was enacted in 1980, it has been only since the mid-1980s that court actions have resulted in some banking organizations being held liable for the clean-up of hazardous substance contamination. These early court decisions had a wide array of interpretations as to whether banking organizations are owners or operators of contaminated facilities and thereby liable under the superfund statute for clean-up costs. These decisions led to uncertainty on the part of banking organizations as to how best to protect themselves from environmental liability.

The relevant provisions of CERCLA, the so-called "superfund" statute as it pertains to banking organizations indicate which persons or entities are subject to liability for clean-up costs of hazardous substance contamination. These include "the owner and operator of a vessel or a facility, (or) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed." A person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning up contamination under the superfund statute.

The liability imposed by the superfund statute is strict liability, which means the government does not have to prove that the owners or operators had knowledge of or caused the hazardous substance contamination. Moreover, liability is joint and several, which allows the government to seek recovery of the entire cost of the clean up from any individual party that is liable for those clean-up costs under CERCLA. In this connection, CERCLA does not limit the bringing of such actions to the EPA but permits such actions to be brought by third parties.

CERCLA provides a secured creditor exemption in the definition of "owner and operator" by stating that these terms do not include "a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security inter-

^{11.} Resource Conservation and Recovery Act of 1987 (RCRA).

^{12.} CERCLA, Section 107(a).

est in the vessel or facility."13 However, this exception has not provided banking organizations with an effective "safe harbor" because early court decisions worked to limit the application of this exemption. Specifically, courts held that actions by lenders to protect their security interests may result in the banking organization "participating in the management" of a vessel or facility, thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the banking organization, courts held that the exemption no longer applies and that the banking organization is liable under the superfund statute as an "owner" of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without the knowledge of preexisting conditions (the so-called "innocent landowner defense"). However, the courts applied a stringent standard to qualify for this defense. Because little guidance is provided by the statute as to what constitutes the appropriate timing and degree of "due diligence" to successfully employ this defense, banking organizations should exercise caution before relying on it.

Overview of Environmental Hazards

Environmental risk can be characterized as adverse consequences resulting from having generated or handled hazardous substances or otherwise having been associated with the aftermath of subsequent contamination. The following discussion highlights some common environmental hazards but by no means covers all environmental hazards.

Hazardous substance contamination is most often associated with industrial or manufacturing processes that involve chemicals or solvents in the manufacturing process or as waste products. For years, these types of hazardous substances were disposed of in land fills or just dumped on industrial sites. Hazardous substances are also found in many other lines of business. The following examples demonstrate the diverse sources of potential hazardous substance contamination, which should be of concern to banking organizations.

 Farmers and ranchers (use of fuel, fertilizers, herbicides, insecticides, and feedlot runoff).

13. CERCLA, Section 101(20)(A).

- Dry cleaners (various cleaning solvents).
- Service station and convenience store operators (underground storage tanks).
- Fertilizer and chemical dealers and applicators (storage and transportation of chemicals).
- Lawn care businesses (application of lawn chemicals).
- Trucking firms (local and long haul transporters of hazardous substances, such as fuel or chemicals).
- The real estate industry has taken the brunt of the adverse affects of hazardous waste contamination. In addition to having land contaminated with toxic substances, construction methods for major construction projects, such as commercial buildings, have utilized materials that have been subsequently determined to be hazardous resulting in significant declines in their value. For example, asbestos was commonly used in commercial construction from the 1950s to the late 1970s. Asbestos was found to be a health hazard and now must meet certain federal and, in many instances, state requirements for costly removal or abatement (enclosing or otherwise sealing off).
- Another common source of hazardous substance contamination is underground storage tanks. Leaks in these tanks not only contaminate the surrounding ground but often flow into ground water and travel far away from the original contamination site. As contamination spreads to other sites, clean-up costs escalate.

Impact on Banking Organization

Banking organizations may encounter losses arising from environmental liability in several ways. The greatest risk to banks resulting from the superfund statute and other environmental liability statutes is the possibility of being held solely liable for costly environmental clean ups, such as hazardous substance contamination. If a bank is found to be a responsible party under CERCLA, it may find itself responsible for cleaning up a contaminated site at a cost that far exceeds any outstanding loan balance. This risk of loss results from an interpretation of the superfund statute as providing for joint and several liability. Any responsible party, including a branch and the foreign banking organization or FBO, as the branch's legal entity, could be forced to pay the full cost of any clean up. Of course, the branch or FBO may attempt to

recover such costs from the borrower, or from the owner, if different than the borrower, provided that the borrower or owner continues in existence and is solvent. Banking organizations may be held liable for the clean up of hazardous substance contaminations in situations where it:

- Takes title to property pursuant to foreclosure;
- Involves the banking organization's personnel or contractors engaged by the bank in day-today management of the facility;
- Takes actions designed to make the contaminated property salable, possibly resulting in further contamination;
- Acts in a fiduciary capacity, including management involvement in the day-to-day operations of industrial or commercial concerns and purchasing or selling contaminated property;
- Owns or acquires (by merger or acquisition), subsidiaries involved in activities that might result in a finding of environmental liability; or
- Owns or acquires, for future expansion, premises that have been previously contaminated by hazardous substances. For example, site contamination at a branch office where a service station with underground storage tanks once operated. Premises or other real estate owned could also be contaminated by asbestos requiring costly clean up or abatement.

A more common situation encountered by banking organizations has been where real property collateral is found to be contaminated by hazardous substances. The value of contaminated real property collateral can decline dramatically depending on the degree of contamination. As the projected clean-up costs increase, the borrower may not be able to provide the necessary funds to remove contaminated materials. In making its determination whether to foreclose, the lender must estimate the potential clean-up costs. In many cases, this estimated cost has been found to be well in excess of the outstanding loan balance and the lender has elected to abandon its security interest in the property and write-off the loan. This situation occurs, regardless of the fact that the superfund statute provides a secured creditor exemption. Some courts have not extended this exemption to situations where lenders have taken title to a property pursuant to foreclosure. These rulings have been based on a strict reading of the statute that provides the exemption to "security interests" only.

Risk of credit losses can also arise where the credit quality of individual borrowers (operators, generators, or transporters of hazardous substances) deteriorates markedly as a result of being required to clean up hazardous substance contamination. Banking organizations must be aware that significant clean-up costs borne by the borrower could threaten the borrower's solvency and jeopardize the lender's ultimate collection of outstanding loans to that borrower regardless of the fact that no real property collateral is involved. Therefore, ultimate collection of loans to fund operations or to acquire manufacturing or transportation equipment can be jeopardized by the borrower's generating or handling of hazardous substances in an improper manner. Further, some bankruptcy courts have required clean up of hazardous substance contamination before distribution of a debtor's estate to secured creditors.

Borrowers may have existing subsidiaries or may be involved in merger and acquisition activity that may place the borrower at risk for the activities of others that result in environmental liability. Some courts have held that for the purposes of determining liability under the superfund statute, the corporate veil may not protect parent companies that participate in the day-to-day operations of their subsidiaries from environmental liability and court imposed clean-up costs. Additionally, borrowers can be held liable for contamination that occurred before they owned or used real estate.

Protection Against Environmental Liability

Lenders have numerous ways to identify and minimize their exposure to environmental liability. Because environmental liability is relatively recent, procedures used to safeguard against such liability are evolving. Generally, however, banking organizations should have in place adequate safeguards and controls to limit their exposure to potential environmental liability. Loan policies and procedures should address methods for identifying potential environmental problems relating to credit requests and existing loans. The loan policy should describe an appropriate degree of due diligence investigation required for credit requests. Borrowers in high-risk industries or localities should be held

to a more stringent due diligence investigation than borrowers in low-risk industries or localities.

In addition to establishing procedures for granting credit, procedures should be developed and applied to portfolio analysis, credit monitoring, loan workout situations, and—before taking title to real property—foreclosures. Banks may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess, and control environmental liability.

At the same time, banking organizations must be careful that any lending policies and procedures, especially those undertaken to assess and control environmental liability, cannot be construed as taking an active role in participating in the management or day-to-day operations of the borrower's business. Activities that could be considered active participation in the management of the borrower's business and therefore subject the banking organization to potential liability, include but are not limited to:

- Having branch or FBO employees serve as members of the borrower's board of directors or actively participating in board decisions;
- Assisting in day-to-day management and operating decisions; or
- · Actively determining management changes.

These considerations are especially important when the banking organization is actively involved in loan workouts or debt restructuring.

The first step in identifying and minimizing environmental risk is for banks to perform environmental reviews. Such reviews may be performed by loan officers or others and typically identify past practices and uses of the facility and property, evaluate regulatory compliance, if applicable, and identify potential future problems. This review is accomplished by interviewing persons familiar with past and present uses of the facility and property, reviewing relevant records and documents, and visiting and inspecting the site.

Where the environmental review reveals possible hazardous substance contamination, an environmental assessment or audit may be required. Environmental assessments are made by personnel trained in identifying potential environmental hazards and provide a more thorough review and inspection of the facility and property. Environmental audits differ markedly from environmental assessments in that independent environmental engineers are employed to

investigate, in greater detail, those factors listed previously and actually test for hazardous substance contamination. Such testing might require collecting and analyzing air samples, surface soil samples, and subsurface soil samples and drilling wells to sample ground water.

Other measures used by some banking organizations to assist in identifying and minimizing environmental liability include obtaining indemnities from borrowers for any clean-up costs incurred by the bank and including affirmative covenants in loan agreements (and attendant default provisions) requiring the borrower to comply with all applicable environmental regulations. Although these measures may provide some aid in identifying and minimizing potential environmental liability, they are not a substitute for environmental reviews, assessments, and audits because their effectiveness is dependent upon the financial strength of the borrower.

The foregoing discussion provides general guidance on environmental liability. Because of continuing legal and regulatory changes and court decisions in this area, all policies, practices, and procedures should be periodically reviewed by legal counsel to ensure that they are adequate and up-to-date.

Conclusion

Potential environmental liability can touch on a great number of loans to borrowers in many industries or localities. Moreover, nonlending activities and affiliations can lead to environmental liability depending upon the nature of these activities and the degree of participation that the banking organization, whether domestic or foreign, exercises in its U.S. operations. Such liability can result in losses arising from hazardous substance contamination because banking organizations are held directly liable for costly court ordered clean ups. Additionally, the banking organization's ability to collect the loans it makes may be hampered by significant declines in collateral value or the inability of a borrower to meet debt payments, after paying for costly clean-ups of hazardous substance contamination.

Banking organizations must understand the nature of environmental liability arising from hazardous substance contamination. Additionally, they should take prudential steps to identify and minimize their potential environmental lia-

bility. Indeed, the common thread to environmental liability is the existence of hazardous

substances, not types of borrowers, lines of business, or real property.

Real Estate Loans Examination Objectives

Effective date July 1997

Section 3100.2

- To determine if policies, practices, procedures, and internal controls regarding real estate lending activities and appraisals are adequate.
- 2. To determine if branch officers are operating in conformance with established guidelines.
- To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
- To determine that appraisals performed in connection with federally-related transactions comply with the minimum standards of

- the appraisal regulations and the Uniform Standards of Professional Appraisal Practice.
- To determine whether adequate safeguards and controls have been established to limit exposure to potential environmental liability.
- 6. To determine compliance with applicable laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Real Estate Loans Examination Procedures

Effective date July 1997

Section 3100.3

Refer to the Credit Risk Management examination procedures for general procedures to assess the risk of real estate lending activities. However, if the branch engages in significant real estate lending activities, and additional information is needed, the examiner should perform the following examination procedures.

- 1. If selected for implementation, complete or update the Internal Control Questionnaire.
- Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
- 3. Review the following information for selected real estate loans:
 - a. Determine the primary source of repayment and evaluate its adequacy.
 - Assess the quality of any secondary collateral afforded by the loan guarantors or partners.
 - c. Compare collateral values to outstanding debt and determine whether the loan's LTV ratio is in excess of the suggested supervisory LTV limits.
 - d. Assess the adequacy of the appraisal or evaluation.
 - e. Determine if the loan complies with branch policy.
 - f. Identify deficiencies in the loan's credit files or the collateral records.
 - g. Review the borrower's compliance with loan covenants, and payment performance.
 - Determine if any problems exist that may jeopardize the repayment of the loan
 - If the loan was classified during the preceding examination and has subsequently been paid off, determine the source of funds for repayment (e.g. another loan, a sale to another institution, or repossession of the property.)
 - j. If the loan is to a firm or to individuals who provided professional services to the branch, such as attorneys, accountants, or appraisers, determine if the borrower received preferential treatment.
- Evaluate the branch's real estate lending activities, taking into account the following items:

- The adequacy of the policies, procedures, and internal controls.
- The adherence to policies and procedures, and accuracy and completeness of the branch's records.
- c. The competency of management and loan officers.
- d. The adequacy of systems to monitor both favorable and adverse trends in the overall real estate industry.
- e. The quality of the real estate loan portfolio, including the level and trends of classified and criticized loans, and delinquent and nonaccrual loans. Ascertain if management is aware of the causes of existing problems.
- f. Loans lacking current and complete financial information or documentation. Address deficiencies related to items such as appraisals, feasibility studies, the environmental impact study, takeout commitment, title policy, deeds of trust, and mortgage notes.
- g. Compliance with laws, regulations, and applicable regulatory policy.
- h. Independent verification of collateral values.

APPRAISALS

- Review the branch's appraisal and evaluation program, making sure it includes guidelines for obtaining appraisals from third party appraisers and evaluating appraisals in-house.
- Evaluate the adequacy and integrity of the appraisal and evaluation process, considering:
 - a. The appropriateness of the methods, assumptions, and techniques used, and compliance with interagency real estate
 - appraisal and evaluation guidelines. b. Other appraisal deficiencies such as:
 - Misrepresentation of data,
 - · Inadequate analysis,
 - Use of dissimilar comparables,
 - Underestimation of factors, such as construction cost, construction period, lease-up period, and rent concessions,

- · Use of best case assumptions for the income approach, or
- Overly optimistic assumptions, such as a high absorption rate in an overbuilt market.

ENVIRONMENTAL LIABILITY

- 7. Determine if policies, procedures, and other safeguards and controls have been established to avoid or mitigate potential environmental liability.
- 8. Determine whether appropriate periodic analysis of potential environmental liability is conducted.
- 9. Review loan agreements to determine if warranties, representations, and indemnifications have been included in loan agreements designed to protect the branch from losses stemming from hazardous substance contamination. (Although such provisions provide some protection for the lender, these agreements are not binding against the government or third parties. Such contractual protections are only as secure as the borrower's financial strength.)
- 10. Update workpapers with any information that will facilitate future examinations.

Internal Control Questionnaire

Effective date July 1997

Section 3100.4

Refer to the Credit Risk Management Internal Control Questionnaire, section 3010.4, for a general review of the branch's internal controls, policies, practices, and procedures. If the branch engages in significant real estate lending activities, and additional information is needed, the examiner should complete the following ICQ. For audit procedures, refer to the Credit Risk Management section 3010.5.

- Has branch and head office management adopted written real estate lending policies that define:
 - a. Target market?
 - b. Acceptable collateral?
 - Prudent, clear, and measurable underwriting standards for each type of property such as:
 - · Maximum loan amount and maturity?
 - Repayment terms?
 - · Pricing structure?
 - · Loan-to-value (LTV) limits?
 - d. Approval procedures and authority limits?
 - e. Loan administration procedures that include documentation, disbursement, collateral inspection, collection, and loan review?
 - f. Minimum loan documentation standards, such as minimum frequency and type of financial information required for each category of real estate loan?
 - g. Appraisals and evaluations?
 - h. Reporting requirements to the head office relative to loan portfolio monitoring, including items such as compliance with lending policies and procedures, delinquency trends, and problem loans?
- 2. Are policies and procedures appropriate to the size and sophistication of the branch, and are they reviewed annually to ensure they are compatible with changing market conditions?
- 3. Has someone been assigned the responsibility for maintaining the document files?
- 4. Are notes and other original documents properly safeguarded?
- 5. Is a tickler system or a check sheet used to ensure that required documents are received and on file?
- 6. Are loan files reviewed after closing to determine if all documents are properly

- drawn, executed, recorded, and filed within the loan files?
- 7. Is there a procedure for monitoring escrow accounts to determine that private mortgage insurance premiums and hazard insurance premiums are current?
- 8. Do hazard insurance policies include a loss payable clause to the branch?
- 9. Are escrow accounts reviewed at least annually to determine if monthly deposits will cover anticipated disbursements?
- 10. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursement?
- 11. Does the branch have adequate collection procedures to monitor delinquencies and pursue foreclosure?
- 12. Are "in-substance foreclosure" properties appropriately identified?
- 13. Are properties to which the branch has obtained title appropriately transferred to other real estate owned (OREO)? Refer to the Other Real Estate Owned section in this manual for requirements.

APPRAISALS AND EVALUATIONS

- 14. Do appraisal policies include:
 - a. Guidelines for selecting, evaluating, and monitoring the individuals performing appraisals or evaluations, whether third party or in-house?
 - b. Procedures for when to obtain appraisals and evaluations on new loans, as well as reappraisals or reevaluations on existing loans?
 - c. Review procedures to determine that appraisals and evaluations comply with supervisory guidelines?
- 15. If appropriate, does the appraisal meet the minimum standards of the appraisal regulations and the Uniform Standards of Professional Appraisal Practice, including:
 - a. Purpose?
 - b. Market value?
 - c. Effective date?
 - d. Marketing period?
 - e. Sales history of subject property?

- f. Reflect the valuation using the cost, income, and comparable sales approaches?
- g. Evaluate and correlate the three approaches into a final value estimate, based on the appraiser's judgment?
- h. Explain why an approach is inappropriate and not used in the appraisal?
- i. Fully support the assumptions and the value rendered through adequate documentation?
- 16. Are staff appraisers independent of the lending, investment, and collection functions?
- 17. Are fee appraisers engaged directly by the branch and do they have no direct or indirect interest, financial or otherwise, in the property or transaction?
- 18. Are fee appraisers paid the same fee whether or not the loan is granted?
- 19. If the transaction is outside the local geographic market of the branch, does the branch engage an appraiser with knowledge of the market where the real estate collateral is located?

ENVIRONMENTAL LIABILITY

- 20. Do loan applicants provide information on environmental matters pertaining to their business facilities?
- 21. If the branch acquires a loan, either by purchase or participation, does it ensure that

- adequate due diligence regarding environmental risk matters has been performed by the lead lender?
- 22. Do loans receive a Phase I Environmental Risk Report if the collateral is deemed to have a higher environmental risk potential than other types of real property?
- 23. Has senior management designated a specific "environmental risk analyst" who receives special training on environmental risk?
- 24. Are potential environmental problems noted in an environmental risk report considered by senior management prior to loan approval?
- 25. Are procedures established for reviewing collateral prior to foreclosure to ensure environmental risk has been addressed?
- 26. Are training programs conducted so that lending personnel are aware of environmental liability issues and are able to identify borrowers with potential problems?

CONCLUSION

- 27. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

INTRODUCTION

A construction loan is used to finance the construction of a particular project within a specified period of time and is funded by supervised disbursements of a predetermined amount over the construction period. When properly controlled, a branch can promote commercial or residential development through its construction lending as well as receive significant profits over a relatively short time frame.

Inasmuch as construction lending is a form of interim financing, loan repayment is contingent upon the borrower either obtaining permanent financing or finding a buyer with sufficient funds to purchase the completed project. Because many borrowers anticipate retaining ownership after construction, the cost and availability of funds from permanent financing is a primary factor to be considered by the branch in assessing the risk of a construction loan.

A construction loan is generally secured by a first mortgage or deed of trust on the land and improvements, which is often backed by a purchase agreement from a financially sound investor or by a takeout financing agreement from a responsible permanent lender. A long-term mortgage loan (permanent financing) is typically obtained prior to or simultaneous with the construction loan and is made to refinance the short-term construction loan. Additionally, the bank may require a borrower to provide secondary collateral in the form of a junior interest in another real estate project or a personal guarantee.

LENDING POLICY

Banks can limit the risk inherent in construction lending by establishing policies that specify the type and extent of branch involvement. The branch's lending policies should reflect prudent lending standards and set forth pricing guidelines, limits on loan-to-value ratios and debt-coverage ratios, and yield requirements. Such policies should also address procedures relative to controlling disbursements in a manner that is commensurate with the construction progress.

Lending Limits

A branch should establish well-controlled construction lending limits that are within the acceptable standards of state banking regulations. State banking statutes governing construction lending may contain minimum standards of prudence without specifying actual loan terms.

The branch's internal limits should not exceed the supervisory loan-to-value (LTV) limits set forth in the Interagency Guidelines for Real Estate Lending Policies, as required by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and included as appendix C of the Federal Reserve's Regulation H. These guidelines, and the accompanying LTV limits, are discussed in the Real Estate Loans section of this manual. Generally, the LTV ratio should not exceed the following supervisory guidance limits:

- 65 percent for raw land loans;
- 75 percent for land development and improved land loans;
- 80 percent for commercial, multifamily, and other nonresidential construction loans; and
- 85 percent for one- to four-family residential construction loans.

The foregoing limits apply only to domestic banks, not to FBOs; however, these guidelines are provided for reference.

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project.

Lending Risks

Construction loans are vulnerable to a wide variety of risks. Critical to the evaluation of any construction loan is the analysis of the project's feasibility study to ascertain the developer's risk, which affects the lender's risk. The major portion of the risk is attributable to the need to complete a project within specified cost and time limits. Examples of difficulties that may arise include:

 Completion of a project after takeout dates, which voids permanent funding commitments.

- Cost overruns, which may exceed takeout commitments or sale prices.
- The possibility that the completed project will be an economic failure.
- The diversion of progress payments resulting in nonpayment of material bills or subcontractors.
- A financial collapse of or the failure of the contractors, subcontractors, or suppliers to perform before the completion date.
- · Increased material or labor costs.
- The destruction of improvements from unexpected natural causes.
- An improper or lax monitoring of funds advanced by the branch.

TYPES OF CONSTRUCTION LOANS

The basic types of construction loans are unsecured front money, land development, residential construction, and commercial construction loans. It is not uncommon for a branch to provide the acquisition, development, and construction loans for a particular project.

Unsecured Front Money Loans

Front money loans are considered very risky and should not be undertaken unless the branch has the expertise to evaluate the credit risk. These loans may represent working capital advances to a borrower who may be engaged in a new and unproven venture. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and meet minimum working capital requirements established by construction lenders. Because repayment often comes from the first draw against construction financing, many construction loan agreements prohibit the use of the first advance to repay nonconstruction costs. Unsecured front money loans used as a developer's equity investment in a project or to cover initial cost overruns are symptomatic of an undercapitalized or possibly an inexperienced or inept builder.

Land Development Loans

Land development or off-site improvement loans are intended to be secured-purchase loans or

unsecured advances to creditworthy borrowers. A development loan involves the purchase of land and lot development in anticipation of further construction or sale of the property. In addition to funding the acquisition of the land, a development loan may be used to fund the preparation of the land for future construction, including the grading of land, installation of utilities, and construction of streets.

Effective administration of a land development loan begins with a plan defining each step of the development. The development plan should incorporate cost budgets, including legal expenses for building and zoning permits, environmental impact statements, costs of installing utilities, and all other projected costs of the development. Branch management's review of the plan and related cost breakdowns should provide the basis for determining the size, terms, and restrictions for the development loan. Refer to the subsection below on the assessment of real estate collateral for further discussion.

The LTV ratio should provide for sufficient margin to protect the branch from unforeseen events (such as unplanned expenses) that would otherwise jeopardize the branch's collateral position or repayment prospects. If the loan involves the periodic development and sale of portions of the property under lien, each separately identifiable section of the project should be independently appraised and any collateral should be released in a manner that maintains a reasonable margin. The repayment program should be structured to follow the sales or development program. Control over development loans can be best established when the branch finances both the development and the construction or sale phases of the project.

In the case of an unsecured land development loan, it is essential to analyze the borrower's financial statements to determine the source of loan repayment. In establishing the repayment program, the branch should review sales projections to ensure that they are not overly optimistic. Additionally, branches should avoid granting loans to illiquid borrowers or guarantors who provide the primary support for a borrower (project).

Residential Construction Loans

Residential construction loans are made either on a speculative basis, where homes are built to be sold later in the general market, or for a specific buyer with prearranged permanent financing. Loans financing residential projects that do not have prearranged home buyer financing are usually limited to a predetermined number of speculative homes, which are permitted to get the project started. It is important to ensure that the home buyer has arranged permanent financing before the branch finances the construction; otherwise, the branch may find itself without a source of repayment. Construction loans without permanent takeout commitments generally should be aggregated to determine whether a concentration of credit exists, that is, in those situations when the amount exceeds the designated percentage of total assets. For further guidance in this area, examiners should consult with their respective agencies.

Proposals to finance speculative construction projects should be evaluated according to predetermined policies that are compatible with the institution's size, the technical competence of its management, and the housing needs of its service area. The prospective borrower's reputation, experience, and financial condition should also be reviewed to assess the likelihood of completing the proposed project. Until the project is completed, the actual value of the real estate is questionable. Thus, the marketability of the project should be substantiated in a feasibility study, reflecting a realistic assessment of current favorable and unfavorable local housing market conditions. As in any real estate loan, the branch must also obtain an appraisal or evaluation for the project. The appraisal or evaluation and the feasibility study are important tools to be used by lenders in evaluating project risks. For projects located out of area, the lender may lack market expertise, which makes evaluating the reasonableness of the marketing plan and feasibility study more difficult, and therefore makes the loan inherently riskier.

A branch dealing with speculative builders should have control procedures tailored to the individual project. A predetermined limit on the number of unsold units to be financed at any one time should be included in the loan agreement to avoid overextending the builder's capacity. The construction lender should receive current inspection reports indicating the project's progress. In some instances, the construction lender is also the permanent mortgagor. Loans on larger residential construction projects are usually negotiated with prearranged permanent financing as part of the construction loan.

Commercial Construction Loans

A branch's commercial construction lending activity can encompass a wide range of projects—apartments, condominiums, office buildings, shopping centers, and hotels—with each requiring a special set of skills and expertise to successfully manage, construct, and market.

Commercial construction loan agreements should normally require the borrower to have a precommitted extended-term loan to "takeout" the construction lender. Takeout financing agreements, however, are usually voidable if construction is not completed by the final funding date, if the project does not receive occupancy permits, or if the preleasing or occupancy rate does not meet an agreed-upon level. A branch can also enter into an "open-end" construction loan where there is no precommitted source to repay the construction loan. Such loans pose an added risk because the branch may be forced into providing permanent financing, oftentimes in distressed situations. In evaluating this risk, the branch should consider whether the completed project will be able to attract extended-term financing, supported by the projected net operating income.

The risk of commercial construction requires a complete assessment of the real estate collateral, borrower's financial resources, source of the extended-term financing, and construction plans. As in any real estate loan, the branch must obtain an appraisal or evaluation of the real estate in accordance with the Federal Reserve's Regulation H. Additionally, the borrower should provide a feasibility study for the project that details the project's marketing plan, as well as an analysis of the supply-and-demand factors affecting the projected absorption rate. For an open-end construction loan, the feasibility study is particularly important to the branch's assessment of the credit because the repayment of the loan becomes increasingly dependent on the sales program or leasing of the project.

The branch also needs to assess the borrower's development expertise, that is, whether the borrower can complete the project within budget and according to the construction plans. The financial risk of the project is contingent on the borrower's development expertise because the source of the extended-term loan may be predicated upon a set date for project completion. Until the project is completed, the actual value of the real estate is questionable.

A branch may reduce its financial risk by funding the construction loan after the borrower has funded its share of the project equity (for example, by paying for the feasibility study and land acquisition and development costs). An alternative approach would require the borrower to inject its own funds into the project at agreed-upon intervals during the project's management, construction, and marketing phases to coincide with the construction lender's contributions. In larger projects, equity injections can be provided by equity partners or joint ventures. These can take the form of equity syndications, with contributions injected in the project in phases. A branch should assess the likelihood of the syndication being able to raise the necessary equity.

BRANCH ASSESSMENT OF THE BORROWER

The term "borrower" can refer to different types of entities. These forms can range from an entity whose sole asset is the project being financed to an entity that has other assets available to support the debt in addition to the project being financed (a multi-asset entity).

Although the value of the real estate collateral is an important component of the loan approval process, the branch should not place undue reliance on the collateral value in lieu of an adequate analysis of the borrower's ability to repay the loan. The analytical factors differ depending on the purpose of the loan, such as residential construction versus the various types of commercial construction loans.

The branch's analysis is contained in its documentation files, which should include background information on the borrower and partner/guarantor concerning their character and credit history, expertise, and financial statements (preferably audited) for the most recent fiscal years. Background information regarding a borrower's and partner's/guarantor's character and credit history is based upon their work experience and previous repayment practices, both relative to trade creditors and financial institutions. The documentation files should indicate whether the borrower has demonstrated the ability to successfully complete the type of project to be undertaken. The financial statements should be

analyzed to ensure that the loan can be repaid in the event that a takeout does not occur.

The degree of analysis depends on whether the borrower is a single-asset entity or a multiasset entity. A loan to a single-asset entity is often predicated upon the strength of the partners/ guarantors. Accordingly, understanding their financial strength, which frequently is made up of various partnership interests, is key to assessing the project's strength. In this example, it would be necessary to obtain financial information on the partner's/guarantor's other projects, even those not financed by the branch, to understand their overall financial condition. This is necessary because other unsuccessful projects may cause financial trouble for the partner/ guarantor, despite a successful sales program by the branch's borrower. Issues to be considered, in addition to those raised in the preceding paragraph, include the vacancy rates of the various projects, break-even points, and rent rolls.

A loan to a multi-asset entity has similar characteristics to those found in the single-asset entity, in that it is necessary to evaluate all of the assets contained therein to ascertain the actual financial strength. In both cases, assessment of the project under construction would include preleasing requirements. For a loan with a takeout commitment, the financial strength and reputation of the permanent lender should be analyzed. For a loan without a takeout commitment, or one where the construction lender provides the permanent financing for its construction loan, the long-term risks also need to be evaluated. Refer to the Real Estate Loans section in this manual, on the branch's assessment of the borrower, for additional factors to be considered.

In instances where approval for the loan is predicated upon the strength of entities other than the borrower (partner/guarantor), the branch should obtain information on their financial condition, income, liquidity, cash flow, contingent liabilities, and any other relevant factors that exist to demonstrate their financial capacity to fulfill the obligation in the event that the borrower defaults.

Partners/guarantors generally have investments in other projects included as assets on their financial statements. The value of these investments frequently represents the partner's/guarantor's own estimate of the investment's worth, as opposed to a value based upon the investment's financial statements. As a result, it

is necessary to obtain detailed financial statements for each investment to understand the partner's/guarantor's complete financial picture and capacity to support the loan. The statements should include detailed current and accurate cash flow information since cash flow is often the source of repayment.

It is also important to consider the number and amount of the guarantees currently extended by a partner/guarantor to determine if they have the financial capacity to fulfill the contingent claims that exist. Furthermore, the branch should review the prior performance of the partner/guarantor to voluntarily honor the guarantee as well as the marketability of the assets collateralizing the guarantee. Since the guarantee can be limited to development and construction phases of a project, the branch should closely monitor the project before issuing a release to the partner/guarantor.

BRANCH ASSESSMENT OF REAL ESTATE COLLATERAL

Branches should obtain an appraisal or evaluation, as appropriate, for all real estate-related financial transactions prior to making the final credit or other decision. Refer to the Real Estate Appraisals and Evaluations section of this manual for a description of the related requirements a branch must satisfy for real estate-related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications necessary for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal methods.

The appraisal or evaluation techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The aggregate principal amount of the loan should be based on an appraisal or evaluation that provides, at a minimum, the "as is" market value of the property. Additionally, the branch will normally request the appraiser to report the "as completed" value. Projections should be accompanied by a feasibility study explaining the effect of projected property improvements on the market value of the land. The feasibility study may be a separate report or incorporated into the appraisal report. If the appraiser uses the feasibility study,

the appraiser's acceptance or rejection of the study and its effect on the value should be fully explained in the appraisal.

Management is responsible for reviewing the reasonableness of the appraisal's or evaluation's assumptions and conclusions. Also, management's rationale in accepting and relying upon the appraisal or evaluation should be documented in writing and made a part of loan documentation. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the branch may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation. Since the approval of the loan is based upon the value of the project after the construction is completed, insofar as the value component of the loan-to-value ratio is concerned, it is important for the branch to closely monitor the project's progress and value during the construction period. Refer to the Real Estate Loans section of the manual for additional information relative to the real estate collateral assessment.

LOAN DOCUMENTATION

The loan documentation should provide information on the essential details of the loan transaction, the security interest in the real estate collateral, and the takeout loan commitment, if any. The necessary documentation before the start of construction generally includes:

- Financial and background information on the borrower to substantiate the borrower's expertise and financial strength to complete the project.
- The construction loan agreement, which sets forth the rights and obligations of the lender and borrower, conditions for advancing funds, and events of default. In some states, the agreement must be cited in either the deed of trust or the mortgage.
- A recorded mortgage or deed of trust, which can be used to foreclose and to obtain title to the collateral.
- A title insurance binder or policy, usually issued by a recognized title insurance com-

pany or, in some states, an attorney's opinion. The title should be updated with each advance of funds to provide additional collateral pro-

- · Insurance policies and proof of payment as evidence that the builder has adequate and enforceable coverage for liability, fire and other hazards, and vandalism and malicious mischief losses.
- An appropriate appraisal or evaluation showing the value of the land and improvements to date or, possibly, a master appraisal based on specifications for a multi-phase development.
- · Project plans, a feasibility study, and a construction budget showing the development plans, project costs, marketing plans, and equity contributions. A detailed cost breakdown of land and "hard" construction costs, as well as indirect or "soft" costs for construction loan interest, organizational and administrative cost, and architectural, engineering, and legal fees should be included.
- · Property surveys, easements, an environmental impact report, and soil reports that indicate construction is feasible on the selected development site. The branch should also obtain the architect's certification of the plan's compliance with all applicable building codes and zoning, environmental protection, and other government regulations, as well as the engineer's report on compliance with building codes and standards. If internal expertise is not available, a branch may need to retain an independent construction expert to review these documents to assess the reasonableness and appropriateness of the construction plans and costs.
- The takeout commitment from the permanent lender, if applicable, and the terms of the loan. The branch should verify the financial strength of the permanent lender to fund the takeout commitment.
- A completion or performance bond signed by the borrower that guarantees that the borrower will apply the loan proceeds to the project being financed.
- An owners' affidavit or a borrowing resolution empowering the borrower or its representative to enter into the loan agreement.
- Evidence that property taxes have been paid to date.

These documents furnish evidence that the lending officer is obtaining the information necessary for processing and servicing the loan and protect the branch in the event of default.

Documentation for Residential Construction Loans on Subdivisions

The documents mentioned above are usually available for residential construction loans on subdivisions (tracts). Documentation of tract loans frequently includes a master note in the gross amount of the entire project, and a master deed of trust covering all of the land involved in the project. In addition to an appraisal or evaluation for each type of house to be constructed, the branch should also obtain a master appraisal including a feasibility study for the entire development. The feasibility study compares the projected demand for housing against the anticipated supply of housing in the market area of the proposed tract development. This analysis should indicate whether there will be sufficient demand for the developer's homes given the project's location, type of homes, and unit sales price.

Documentation for Takeout Commitment

Most construction lenders require the developer to have an arrangement for permanent financing for each house to be constructed. Exceptions include model homes, typically one for each style of home offered, and a limited number of housing starts ahead of sales (speculative building). The starts ahead of sales, however, contain additional risk. If the branch finances too many houses without purchase contracts, and housing sales decline rapidly, it may have to foreclose on the unsold houses and sell them for less than their loan value. A takeout of this type is usually an arrangement between the developer and a permanent mortgage lender, but construction lenders may also finance the permanent mortgages.

The essential information required for a commercial real estate takeout to proceed includes the floor and ceiling rental rates and minimum occupancy requirements; details of the project being financed; expiration date; standby fee requirement; assignment of rents; and, generally, a requirement that the construction loan be fully disbursed and not in any way be in default at the time settlement occurs.

The commitment agreement, referred to as a buy/sell contract or a tri-party agreement, is signed by the borrower, the construction lender, and the permanent lender. The purpose of this agreement is to permit the permanent lender to buy the loan directly from the construction lender upon completion of the construction, with the stipulation that all contingencies have been satisfied. Examples of contingencies include project completion by the required date, clear title to the property, and minimum lease-up requirements. A commitment agreement also protects the construction lender against unforeseen possibilities, such as the death of a principal, before the permanent loan documents are signed.

LOAN ADMINISTRATION

The branch and the borrower must effectively cooperate as partners if controls relative to construction progress are to be maintained. The loan agreement specifies the performance of each party during the entire course of construction. Any changes in construction plans should be approved by both the construction lender and the takeout lender. Construction changes can result in increased costs, which may not necessarily increase the market value of the completed project. On the other hand, a decrease in costs may not indicate a savings but may suggest the use of lesser quality materials or workmanship, which could affect the marketability of the project.

Disbursement of Loan Funds

Loan funds are generally disbursed through either a stage payment plan or a progress payment plan. Regardless of the method of disbursement, the amount of each construction draw should be commensurate with the improvements made to date. Funds should not be advanced unless they are used in the project being financed and as stipulated in the draw request. Therefore, the construction lender must monitor the funds being disbursed and must be assured, at every stage of construction, that sufficient funds are available to complete the project.

Stage Payment Plan

The stage payment plan, which is normally applied to residential and smaller commercial construction loans, uses a pre-established schedule for fixed disbursements to the borrower at the end of each specified stage of construction. The amount of the draw is usually based upon the stage of development because residential housing projects normally consist of houses in various stages of construction. Nevertheless, loan agreements involving tract financing typically restrict further advances in the event of an accumulation of completed and unsold houses. Disbursements are made when construction has reached the agreed-upon stages, verified by an actual inspection of the property. These typically include advances at the conclusion of various stages of construction, such as the foundation, exterior framing, the roof, interior finishing, and completion of the house. The final payment is made after the legally stipulated lien period for mechanic's liens has lapsed.

Disbursement programs of this type are usually required for each house constructed within a tract development. As each house is completed and sold, the branch makes a partial release relative to that particular house covered by its master deed of trust. The amount of the release is set forth in the loan agreement, which specifies the agreed-upon release price for each house sold with any excess over the net sales proceeds remitted to the borrower.

Progress Payment Plan

The progress payment plan is normally used for commercial projects. Under a progress payment system, funds are released as the borrower completes certain phases of construction as agreed upon in the loan agreement. Normally, the branch retains a percentage of the funds as a hold-back (or retainage) to cover project cost overruns or outstanding bills from suppliers or subcontractors. Hold-backs occur when a developer/contractor uses a number of subcontractors and maintains possession of a portion of the amounts owed to the subcontractors during the construction period. This is done to ensure that the subcontractors finish their work before receiving the final amount owed. Accordingly, the construction lender holds back the same funds from the developer/contractor to avert the risk of their misapplication or misappropriation.

The borrower presents a request for payment from the branch in the form of a "construction draw" request or "certification for payment," which sets forth the funding request by construction phase and cost category for work that has been completed. This request should be accompanied by receipts for the completed work (material and labor) for which payment is being requested. The borrower also certifies that the conditions of the loan agreement have been met—that all requested funds have been used in the subject project and that suppliers and subcontractors have been paid. Additionally, the subcontractors and suppliers should provide the branch with lien waivers covering the work completed for which payment has been received. Upon review of the draw request and independent confirmation on the progress of work, the branch will disburse funds for construction costs incurred, less the hold-back. The percentage of the loan funds retained are released when a notice of the project's completion has been filed, and after the stipulated period has elapsed under which subcontractors or suppliers can file a lien.

Monitoring Progress of Construction and Loan Draws

It is critical that a branch has appropriate procedures and an adequate tracking system to monitor payments to ensure that the funds requested are appropriate for the given stage of development. The monitoring occurs through physical inspections of the project once it has started. The results of the inspections are then documented in the inspection reports, which are kept in the appropriate file. Depending on the complexity of the project, the inspection reports can be completed either by the lender or by an independent construction consulting firm, the latter generally staffed by architects and engineers. The reports address both the quantity and the quality of the work for which funds are being requested. They also verify that the plans are being followed and that the construction is proceeding on schedule and within budget.

The branch must be accurately informed of the progress to date in order to monitor the loan. It is also important that the branch ascertain whether draws are being taken in accordance with the predetermined disbursement schedule. Before any draw amount is disbursed, however, the branch must obtain verification of continued title insurance. Generally, this means verifying that no liens have been filed against the title of the project since the previous draw. The title insurance insuring the construction lender's mortgage or lien is then increased to include the new draw, which results in an increase in the title insurance commensurate with the disbursement of funds. The lender frequently examines title to the property securing the construction loan to also be certain that the borrower is not pledging it for other borrowings and to be sure that mechanic's liens are not being filed for unpaid bills. When the project is not proceeding as anticipated, that fact should be reflected in the inspection reports.

Another important component in the process is the ongoing monitoring of general economic factors that will affect the marketing and selling of the residential or commercial properties and affect their success upon completion of the project.

Monitoring Residential Projects

An inventory list is maintained for each tract or phase of the project. The inventory list should show each lot number, the style of house, the release price, the sale price, and the loan balance. The list should be posted daily with advances and payments indicating the balance advanced for each house, date completed, date sold, and date paid, and should age the builder's inventory by listing the older houses completed and unsold.

Inspections (usually monthly) during the course of construction of each house should be documented in progress reports. The progress report should indicate the project's activity during the previous month, reflecting the number of homes under construction, the number completed, and the number sold. The monthly report should indicate whether advances are being made in compliance with the loan agreement.

Monitoring Commercial Projects

To have an effective control over its commercial construction loan program, the branch must have an established loan administration process that continually monitors each project. The pro-

cess should include monthly reporting on the work completed, the cost to date, the cost to complete, construction deadlines, and loan funds remaining. Any changes in construction plans should be documented and reviewed by the construction consulting firm and should be approved by the branch and takeout lender. A significant number of change orders may indicate poor planning or project design, or problems in construction, and should be tracked and reflected in the project's budget. Soft costs such as advertising and promotional expenses normally are not funded until the marketing of the project has started.

Final Repayment

Before the final draw is made, the construction loan should be in a condition to be converted to a permanent loan. Usually the final draw includes payment of the hold-back stipulated in the loan agreement and is used to pay all remaining bills. The branch should obtain full waivers of liens (releases) from all contractors, subcontractors, and suppliers before the loan is released and the hold-back is disbursed. The branch should also obtain a final inspection report to confirm the project is completed and meets the building specifications, including confirmation of the certificate of occupancy from the governing building authority.

Sources of permanent funding for commercial projects vary greatly, depending upon the type of project. For condominium projects, the construction lender may also be providing the funding for marketing the individual units and would be releasing the loan on a unit-by-unit basis similar to a residential development construction loan. If there is a pre-committed takeout lender, the new lender could purchase the construction loan documents and assume the security interest from the construction lender. If the project is being purchased for cash, the branch would release its lien and cancel the note.

Additionally, as the commercial project is leased, the lender should ensure that the branch's position is protected in the event that extended-term funding is not obtained. The branch may require tenants to enter into subordination, attornment, and nondisturbance agreements, which protect the branch's interests in the lease by providing for the assumption of the land-

lord's position by the branch in the event the borrower declares bankruptcy. Furthermore, to ensure that the branch has full knowledge of all provisions of the lease agreements, tenants should be required to sign an estoppel certification

In some cases, the takeout lender may only pay off a portion of the construction loan because a conditional requirement for full funding has not been met, such as the project not attaining a certain level of occupancy. The construction lender would then have a second mortgage on the remaining balance of the construction loan. When the conditions of the takeout loan are met, the construction lender is repaid in full and the lien is released.

Interest Reserves

A construction loan is generally an interest-only loan because of the fact that cash flow is not available from most projects until they are completed. The borrower's interest expense is therefore borrowed from the construction lender as part of the construction loan for the purpose of "paying" the lender interest on the "portion" of the loan used for actual construction. The funds advanced to pay the interest are included as part of the typical monthly draw. As a result, the balance due to the lender increases with each draw by the full amount of construction costs, plus the interest that is borrowed.

The borrower's interest cost is determined by the amount of credit extended and the length of time needed to complete the project. This interest cost is referred to as an interest reserve. This period of time should be evaluated for reasonableness relative to the project being financed. In larger projects, cash flow may be generated prior to the project's completion. In such cases, any income from the project should be applied to debt service before there is a draw on the interest reserve. The lender should closely monitor the lease-up of the project to ensure that the project's net income is being applied to debt service and not diverted to the borrower as a return of the developer's capital or for use in the developer's other projects.

Loan Default

The inherent exposure in construction financing is that the full value of the collateral is not

realized until the project is completed. In default situations the branch must consider the alternatives available to recover its advances. For incomplete projects, the branch must decide whether it is more advantageous to complete the project or to sell on an "as is" basis. The various mechanic's and materialmen's liens, tax liens, and other judgments that arise in such cases are distressing to even the most seasoned lender. Due to these factors, the construction lender may not be in the preferred position indicated by documents in the file. Therefore, the lender should take every precaution to minimize any third-party claim on the collateral. Because laws regarding the priority of certain liens may vary among states, the branch should take the necessary steps to ensure that its lien is recorded prior to the commencement of work or the delivery of materials and supplies.

Signs of Problems

To detect signs of a borrower's financial problems, the branch should review the borrower's financial statements on a periodic (quarterly) basis, assessing the liquidity, debt level, and cash flow. The degree of information the financial statements provide the branch, insofar as understanding the borrower's financial condition is concerned, depends primarily on whether the borrower is a single-asset entity or a multiasset entity.

The financial statements of a single-asset entity only reflect the project being constructed; therefore, they are of a more limited use than statements of multi-asset entities. Nevertheless, one issue that is of importance to financial statements of both entities relates to monitoring changes in accounts and trade payables. Monitoring these payables in a detailed manner helps the branch to determine if trade payables are paid late or if there are any unpaid bills. In the event of problems, a branch might choose to either contact the payables directly or request an additional credit check on the borrower. Another source of information indicating borrower problems is local publications that list lawsuits or judgments that have been filed or entered against the borrower. Additionally, the branch should also verify that the borrower is making its tax payments on time.

In a multi-asset entity, on the other hand, more potential problems could arise due to the

greater number of assets (projects/properties) that make up the borrower. As a result, it is necessary to obtain detailed financial statements of each of the assets (projects/properties) and the consolidating financial statements, as well as the consolidated financial statements. This is important because each kind of statement can provide significant insight into problems that could adversely affect the borrower's overall financial condition.

Assessing the financial condition of the multiasset entity includes evaluating the major sources of cash and determining whether cash flow is dependent on income generated from completed projects, the sale of real estate, or infusion of outside capital. Additionally, the branch should also review the borrower's account receivables for the appropriateness of intercompany transactions and to guard against diversion of funds.

Depending upon the structure of the loan, it may also be desirable to obtain a partner's/guarantor's financial statements on a periodic basis. In such cases it is important to obtain detailed current and accurate financial statements that include cash flow information on a project-by-project basis.

Slow unit sales, or excessive inventory relative to sales, indicate the borrower may have difficulty repaying the loan. Although sometimes there are mitigating factors beyond the control of the borrower, such as delays in obtaining materials and supplies, adverse weather conditions, or unanticipated site work, the borrower may be unable to overcome these problems. Such delays usually increase project costs and could hamper the loan's repayment.

The construction lender should be aware of funds being misused—for example, rebuilding to meet specification changes not previously disclosed, starting a new project, or possibly paying subcontractors for work performed elsewhere. The practice of "front loading," whereby a builder deliberately overstates the cost of the work to be completed in the early stages of construction, is not uncommon and, if not detected early on, will almost certainly result in insufficient loan funds available to complete construction in the event of a default.

Loan Workouts

Sound workout programs begin with a full disclosure of all relevant information based on a

realistic evaluation of the borrower's ability to manage the business entity (business, technical, and financial capabilities), and the branch's ability to assist the borrower in developing and monitoring a feasible workout/repayment plan. Management should then decide on a course of action to resolve the problems, with the terms of the workout documented in writing and formally agreed to by the borrower. If additional collateral is accepted or substituted, the branch should ensure that the necessary legal documents are filed to protect the branch's collateral position.

In those cases where the borrower is permitted to finish the project, additional extensions of credit for completing the project, due to cost overruns or an insufficient interest reserve, may represent the best alternative for a workout plan. At the same time, the branch should evaluate the cause of the problem(s), such as mismanagement, and determine whether it is in its best interest to allow the borrower to complete the project.

SUPERVISORY POLICY

As a result of competitive pressures, many branches in the early 1980s made construction loans on an open-end basis, wherein the borrower did not have a commitment for longer-term or takeout financing before construction was started. Although there was sufficient demand for commercial real estate space when this practice commenced, the supply of space began to exceed demand. One symptom of the excess supply was an increase in vacancy rates,

which led to declining rental income caused by the ever greater need for rent concessions. This decline in cash flow from income-producing properties, and the uncertainty regarding future income, reduced the market value of many properties to levels considered undesirable by permanent mortgage lenders. As a result of the subsequent void created by the permanent lenders, banks in the mid- and late-1980s began to extend medium-term loans with maturities of up to seven years (also referred to as mini-perms). These mini-perms were granted with the expectation by banks that as the excess supply of space declined, the return on investment would improve, and permanent lenders would return.

As these loans mature in the 1990s, borrowers may continue to find it difficult to obtain adequate sources of long-term credit. In some cases, banks may determine that the most desirable and prudent course is to roll over or renew loans to those borrowers who have demonstrated an ability to pay interest on their debts, but who presently may not be in a position to obtain long-term financing for the loan balance.

The act of refinancing or renewing loans to sound borrowers, including creditworthy commercial or residential real estate developers, generally should not be subject to supervisory criticism in the absence of well-defined weaknesses that jeopardize repayment of the loans. Refinancings or renewals should be structured in such a manner that is consistent with sound banking principles, supervisory guidelines, and accounting practices, which would protect the branch and improve its prospects for collecting or recovering on the asset.

Real Estate Construction Loans Examination Objectives

Effective date July 1997

Section 3110.2

- To determine if policies, practices, procedures, and internal controls regarding real estate construction loans are adequate.
- To determine if branch officers are operating in conformance with the branch's established guidelines.
- 3. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
- To determine compliance with applicable laws and regulations.
- To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Real Estate Construction Loans Examination Procedures

Effective date July 1997

Section 3110.3

Refer to the Real Estate Loan Examination Procedures section of this manual for examination procedures related to all types of real estate lending activity, and incorporate into this checklist those procedures applicable to the review of the real estate construction loans. The procedures in this checklist are unique to the review of a branch's construction lending activity.

- Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal/external auditors.
- 2. Test real estate construction loans for compliance with policies, practices, procedures, and internal controls by performing the remaining examination procedures in this section. Also, obtain a listing of any deficiencies noted in the latest internal/external audit reviews and determine if appropriate corrections have been made. Review management's actions taken in response to prior examination comments.
- Review management reports on the status of construction lending activity, economic developments in the market, and problem loan reports.
- 4. Evaluate the branch with respect to:
 - a. the adequacy of written policies and procedures relating to construction lending.
 - b. operating compliance with established branch policy.
 - c. favorable or adverse trends in construction lending activity.
 - d. the accuracy and completeness of the branch's records.
 - e. the adequacy of internal controls, including control of construction draws.
 - f. the adherence of lending staff to lending policies, procedures, and authority as well as the branch's adherence to the holding company's loan limits, if applicable.
 - g. compliance with laws, regulations, and Federal Reserve policy on construction lending activity, including supervisory loan-to-value (LTV) limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and prudent lending practices.
- Select loans for examination, using an appropriate sampling technique. Analyze the per-

formance of the loans selected for examination by transcribing the following kinds of information onto the real estate construction loan line cards, when applicable:

- a. Collateral records and credit files, including the borrower's financial statements, review of related projects, credit report of the borrower and guarantors, appraisal or evaluation of collateral, feasibility studies, economic impact studies, and loan agreement and terms.
- b. Loan modification or restructuring agreements to identify loans where interest or principal is not being collected according to the terms of the original loan. Examples include reduction of interest rate or principal payments, deferral of interest or principal payments, or renewal of a loan with accrued interest rolled into the principal.
- c. The commitment agreement, buy/sell contract, or the tri-party agreement from the extended-term or permanent lender for the takeout loan.
- d. Cash-flow projections and any revisions to projections based on cost estimates from change orders.
- Estimates of the time and cost to complete construction.
- f. Inspection reports and evaluations of the cost to complete, construction deadlines, and quality of construction.
- g. Construction draw schedules and audits for compliance with the schedules.
- h. Documentation on payment of insurance and property taxes.
- Terms of a completion or performance bond.
- j. Past-due/nonaccrual-related information.
- Loan-specific internal problem credit analyses information.
- 1. Loans to insiders and their interests.
- m. Loans classified during the preceding examination.
- In analyzing the selected construction loans, the examiner should consider the following procedures, taking appropriate action if necessary:
 - Determine the primary source of repayment and evaluate its adequacy, including whether:

- the permanent lender has the financial resources to meet its commitment.
- the amount of the construction loan and its estimated completion date correspond to the amount and expiration date of the takeout commitment and/or completion bond.
- the permanent lender and/or the bonding company have approved any modifications to the original agreement.
- properties securing construction loans that are not supported by a takeout commitment will be marketable upon completion.
- b. Analyze secondary support afforded by guarantors and partners.
- c. Relate collateral values to outstanding debt by:
 - assessing the adequacy of the appraisal and evaluation.
 - ascertaining whether inspection reports support disbursements to date.
 - determining whether the amount of undisbursed loan funds is sufficient to complete the project.
 - establishing whether title records assure the primacy of the branch's liens.
 - determining if adequate hazard, builder's risks, and worker's compensation insurance is maintained.
- d. Determine whether the loan-to-value (LTV) ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.
- e. Ascertain whether the loan complies with established branch policy.
- f. Identify any deficiencies in the loan's documentation in both the credit files and the collateral records.
- g. Identify whether the loan is to an officer or director of the branch or to a correspondent bank, and whether an officer, director, or shareholder of the bank is a guarantor on the loan.
- Review the borrower's compliance with the provisions of the loan agreement, indicating whether the loan is in default or in past-due status.
- Determine if there are any problems that may jeopardize the repayment of the construction loan.

- j. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank or from the repossession of the property.
- 7. In connection with the examination of other lending activity in the branch, the examiner should check the central liability file on the borrower(s) and determine whether the total construction lending activity exceeds the lending limit to a single borrower.
- 8. Summarize the findings of the construction loan portfolio review and address:
 - a. the scope of the examination.
 - b. the quality of the policies, procedures, and controls.
 - c. the general level of adherence to policies and procedures.
 - d. the competency of management.
 - e. the quality of the loan portfolio.
 - loans not supported by current and complete financial information.
 - g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, feasibility studies, the environmental impact study, takeout commitment, title policy, construction plans, inspection reports, change orders, proof of payment for insurance and taxes, deeds of trust, and mortgage notes.
 - h. the adequacy of control over construction draws and advances.
 - loans to officers, directors, shareholders, or their interests.
 - j. causes of existing problems.
 - k. delinquent loans and the aggregate amount of statutory bad debts. Refer to the manual section on classification of credits for a discussion on statutory bad debts or "A" paper.
 - 1. concentrations of credit.
 - m. classified loans.
 - violations of laws or regulations, and noncompliance with regulatory requirements.
 - action taken by management to correct previously noted deficiencies and corrective actions recommended to management at this examination, with the branch's response to such recommendations.

Real Estate Construction Loans Internal Control Questionnaire

Effective date July 1997

Section 3110.4

POLICIES AND OBJECTIVES

- Has the head office and branch management adopted and written construction lending policies that:
 - a. outline construction lending objectives regarding:
 - the aggregate limit for construction loans?
 - concentrations of credit in particular types of construction projects?
 - b. establish minimum standards for documentation?
 - c. define qualified collateral and minimum margin requirements?
 - d. define the minimum equity requirement for a project?
 - e. define loan-to-value (LTV) limits that are consistent with supervisory LTV limits?
 - f. require an appraisal or evaluation that complies with the Federal Reserve real estate appraisal regulation and guidelines?
 - g. delineate standards for takeout commitments?
 - h. indicate completion bonding requirements?
 - i. establish procedures for reviewing construction loan applications?
 - j. detail methods for disbursing loan proceeds?
 - k. detail project inspection requirements and progress reporting procedures?
 - 1. require agreements by borrowers for completion of improvements according to approved construction specifications, and cost and time limitations?
- 2. Are construction lending policies and objectives appropriate to the size and sophistication of the branch, and are they compatible with changing market conditions?

DOCUMENTATION

- 3. Does the branch require and maintain the following documentation:
 - a. the contractor's payment of:
 - employee withholding taxes?
 - builder's risk insurance?
 - · worker's compensation insurance?

- public liability insurance?
- completion insurance?
- b. the property owner's payment of real estate taxes?
- 4. Does the branch require that files include:
 - a. loan applications?
 - b. financial statements for the:
 - borrower?
 - builder?
 - proposed prime tenant?
 - · takeout lender?
 - guarantors/partners?
 - c. credit and trade checks on the:
 - borrower?
 - builder?
 - · major subcontractor?
 - proposed tenants?
 - d. a copy of plans and specifications?
 - e. a copy of the building permit?
 - f. a survey of the property?
 - g. the construction loan agreement?
 - h. an appraisal or evaluation and feasibility study?
 - i. an up-to-date title search?
 - i. the mortgage?
 - k. ground leases?
 - 1. assigned tenant leases or letters of intent to lease?
 - m. a copy of the takeout commitment?
 - n. a copy of the borrower's application to the takeout lender?
 - o. the tri-party buy-and-sell agreement?
 - p. inspection reports?
 - q. disbursement authorizations?
 - r. undisbursed loan proceeds and contingency or escrow account reconcilements?
 - s. insurance policies?
- 5. Does the branch employ standardized checklists to control documentation for individual files and perform audit reviews for adequacy?
- 6. Does the documentation file indicate all of the borrower's other loans and deposit account relationships with the branch and a summary of other construction projects being financed by other banks? Does the branch analyze the status of these projects and the potential effect on the borrower's financial position?
- 7. Does the branch use tickler files that:
 - a. control scheduling of inspections and disbursements?

- b. assure prompt administrative follow-up on items sent for:
 - · recording?
 - · attorney's opinion?
 - expert review?
- Does the branch maintain tickler files that provide advance notice (such as 30 days' prior notice) to staff of the expiration dates for:
 - a. the takeout commitment?
 - b. hazard insurance?
 - c. worker's compensation insurance?
 - d. public liability insurance?

REVIEWING LOAN APPLICATIONS

- 9. Does branch policy require a personal guarantee from the borrower on construction loans?
- 10. Does branch policy require personal completion guarantees by the property owner and/or the contractor?
- 11. Does the branch require a construction borrower to contribute equity to a proposed project in the form of money or real estate? If so, indicate the form of equity contributed.
- 12. Does the project budget include the amount and source of the builder's and/or owner's equity contribution?
- 13. Does the branch require:
 - a. background information on the borrower's, contractor's, and major subcontractors' development and construction experience, as well as other projects currently under construction?
 - b. payment history information from suppliers and trade creditors on the aforementioned's previous projects?
 - c. credit reports?
 - d. detailed current and historical financial statements, including cash flow-related information?
- 14. Do the borrower's project cost estimates include:
 - a. land and construction costs?
 - b. off-site improvement expenses?
 - c. soft costs, such as organizational and administrative costs, and architectural, engineering, and legal fees?
 - d. interest, taxes, and insurance expenses?
- 15. Does the branch require an estimated cost breakdown for each stage of construction?

- 16. Does the branch require that cost estimates of more complicated projects be reviewed by qualified personnel: experienced in-house staff, an architect, construction engineer, or independent estimator?
- 17. Are commitment fees required on approved construction loans?

CONSTRUCTION LOAN AGREEMENT

- 18. Is the construction loan agreement signed before an actual loan disbursement is made?
- Is the construction loan agreement reviewed by counsel and other experts to determine that improvement specifications conform to:
 - a. building codes?
 - b. subdivision regulations?
 - c. zoning and ordinances?
 - d. title and/or ground lease restrictions?
 - e. health and handicap access regulations?
 - f. known or projected environmental protection considerations?
 - g. specifications required under the National Flood Insurance Program?
 - h. provisions in tenant leases?
 - i. specifications approved by the permanent lender?
 - j. specifications required by the completion or performance bonding company and/or guarantors?
- 20. Does the branch require all change orders to be approved in writing by the:
 - a. branch?
 - b. branch's counsel?
 - c. permanent lender?
 - d. architect or supervising engineer?
 - e. prime tenants bound by firm leases or letters of intent to lease?
 - f. completion bonding company?
- 21. Does the construction loan agreement set a date for project completion?
- 22. Does the construction loan agreement require that:
 - a. the contractor not start work until authorized to do so by the branch?
 - b. on-site inspections be permitted by the lending officer or an agent of the branch without prior notice?
 - disbursement of funds be made as work progresses, supported by documentation that the subcontractors are receiving pay-

- ment and that the appropriate liens are being released?
- d. the branch be allowed to withhold disbursements if work is not performed according to approved specifications?
- e. a percentage of the loan proceeds be retained pending satisfactory completion of the construction?
- f. the lender be allowed to assume prompt and complete control of the project in the event of default? If a commercial project, are the leases assignable to the branch?
- g. the contractor carry builder's risk and worker's compensation insurance? If so, has the branch been named as mortgagee or loss payee on the builder's risk policy?
- h. periodic increases in the project's value be reported to the builder's risk and title insurance companies?
- 23. In addition to the aforementioned points, does the construction loan agreement for residential tract construction loans require:
 - a. branch authorization for individual tract housing starts?
 - b. periodic sales reports be submitted to the branch?
 - c. periodic reports on tract houses occupied under a rental, lease, or purchase option agreement be submitted to the branch?
 - d. limitations on the number of speculative houses and the completion of one tract prior to beginning another?

COLLATERAL

- 24. Are liens filed on non-real estate construction improvements, i.e., personal property that is movable from the project?
- 25. When entering into construction loans, does the branch, consistent with supervisory loanto-value limits:
 - a. limit the loan amount to a reasonable percentage of the appraised value of the project when there is no prearranged permanent financing?
 - b. limit the loan amount to a percentage of the appraised value of the completed project when subject to the branch's own takeout commitment?
 - c. limit the loan amount to the floor of a takeout commitment that is based upon achieving a certain level of rents or lease occupancy?

- 26. Are unsecured credit lines to contractors or developers, who are also being financed by secured construction loans, supervised by the construction loan department or the officer supervising the construction loan?
- 27. Does the branch have adequate procedures to determine whether construction appraisal or evaluation policies and procedures are consistently being followed in conformance with regulatory requirements, and that the appraisal or evaluation documentation supports the value indicated in the conclusions?

INSPECTION

- 28. Are inspection authorities noted in the:
 - a. construction loan commitment?
 - b. construction loan agreement?
 - c. tri-party buy-and-sell agreement?
 - d. takeout commitment?
- 29. Are inspections conducted on an irregular basis?
- 30. Are inspection reports sufficiently detailed to support disbursements?
- 31. Are inspectors rotated from project to project?
- 32. Are spot checks made of the inspectors' work?
- 33. Do inspectors determine compliance with plans and specifications as well as the progress of the work? If so, are the inspectors competent to make the determination?

DISBURSEMENTS

- 34. Are disbursements:
 - a. advanced on a prearranged disbursement plan?
 - b. made only after reviewing written inspection reports?
 - c. authorized in writing by the contractor, borrower, inspector, subcontractors, and/or lending officer?
 - d. reviewed by a branch employee who had no part in granting the loan?
 - e. compared to original cost estimates?
 - f. checked against previous disbursements? g. made directly to subcontractors and
 - suppliers?
 h. supported by invoices describing the
 - h. supported by invoices describing the work performed and the materials furnished?

- 35. Does the branch obtain waivers of subcontractor's and mechanic's liens as work is completed and disbursements are made?
- 36. Does the branch obtain sworn and notarized releases of mechanic's liens from the general contractor at the time construction is completed and before final disbursement is made?
- 37. Does the branch periodically review undisbursed loan proceeds to determine their adequacy to complete the projects?
- 38. Are the borrower's undisbursed loan proceeds and contingency or escrow accounts independently verified at least monthly by someone other than the individuals responsible for loan disbursements?

TAKEOUT COMMITMENT

- 39. Does counsel review takeout agreements for acceptability?
- 40. Does the branch obtain and review the permanent lender's financial statements to determine the adequacy of its financial resources to fulfill the takeout commitment?
- 41. Is a tri-party buy-and-sell agreement signed before the construction loan is closed?
- 42. Does the branch require takeout agreements to include a force majeure (an act of God clause) that provides for an automatic extension of the completion date in the event that construction delays occur for reasons beyond the builder's control?

COMPLETION BONDING REQUIREMENTS

- 43. Does the branch require completion insurance for all construction loans?
- 44. Has the branch established minimum financial standards for borrowers who are not required to obtain completion bonding? Are these standards observed in all cases?
- 45. Does counsel review completion insurance bonds for acceptability?

LOAN RECORDS

46. Are the preparation, addition, and posting of subsidiary real estate construction loan

- records performed or adequately reviewed by persons who do not also:
- a. issue official checks or drafts?
- b. handle cash?
- c. reconcile subsidiary records to general ledger controls?
- 47. Are the subsidiary real estate construction loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?
- 48. Are loan statements, delinquent account collection requests, and past-due notices reconciled to the real estate construction loan subsidiary records? Are the reconciliations handled by a person who does not also handle cash?
- 49. Are inquiries about construction loan balances received and investigated by persons who do not also handle cash?
- 50. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
- 51. Is a delinquent accounts report generated daily?
- 52. Are loans in excess of supervisory LTV limits identified in the branch's records and are the aggregate amounts of such loans reported at least quarterly to the board of directors?
- 53. Does the branch maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
- 54. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?

LOAN INTEREST AND COMMITMENT FEES

- 55. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not
 - a. issue official checks or drafts?
 - b. handle cash?
- 56. Are any independent interest and fee computations made and compared or adequately

tested to loan interest by persons who do not also:

- a. issue official checks or drafts?
- b. handle cash?

- this area? If not, indicate any additional examination procedures deemed necessary.
- 58. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

CONCLUSION

57. Is the information covered by this ICQ adequate for evaluating internal controls in

Real Estate Construction Loans Audit Guidelines

Effective date July 1997

Section 3110.5

Refer to the Credit Risk Management, Audit Guidelines, section of this manual for items applicable to Real Estate Construction Loans.

- 1. Using appropriate sampling techniques, select loans from the trial balance and:
 - a. Review loan agreement provisions for hold back or retention, and determine if undisbursed loan funds and/or contingency or escrow accounts are equal to retention or holdback requirements.
 - b. If separate interest reserves are maintained, determine if debit entries to those

- accounts are authorized in accordance with the terms of the loan agreement and if they are supported by inspection reports, certificates of completion, individual bills, or other evidence.
- Review disbursement ledgers and authorizations and determine if authorizations are signed according to the terms of the loan agreement.
- d. Verify debits in the undisbursed loan proceeds accounts to inspection reports, individual bills, or other evidence supporting disbursements.

Effective date July 1997

Some branches provide lending services to stock brokerage firms using stock of listed corporations as collateral. To promote efficiency in the pledging of collateral, the Stock Clearing Corporation, a wholly-owned subsidiary of the New York Stock Exchange, transfers stock ownership through computer book entries and thus eliminates the physical movement of the securities. The operating department of the Stock Clearing Corporation, Central Certificate Service (CCS), handles the technical aspects of that operation.

Brokerage firms deposit shares of eligible securities with CCS. The stock certificates representing those shares are registered in the name of a common nominee. CCS has physical control of the securities while they are on deposit. Loan arrangements are made between the broker and the lending branch with the broker instructing CCS, through written authorization, to debit the firm's account and credit that of the branch. CCS sends a copy of the authorization to the branch and will not reverse the entry or make partial withdrawals without written authorization from the branch. Participating financial institutions receive daily printouts, showing their position in the program by broker name and type of security. Because of adequately protected controls employed by Stock Clearing Corporation, examiners should accept the daily position printouts without further verification.

COMMODITY LOANS

Loans to carry investments in commodities entail the same basic criteria as in all credit relationships. Borrowers are typically nonproducers or nonprocessors of the commodity and include individuals, trading companies, manufacturers, or broker/dealers. The loan may represent a direct investment in the commodity or the carrying of a forward or futures position in the commodity. The commodity being purchased generally secures the borrowing. Common purposes for commodity loans include:

- The temporary holding by a trader of a commodity under contract for sale or in anticipation of sale in the near term.
- The holding of a commodity by an entity in anticipation of price appreciation for that commodity.
- The holding of a commodity by a manufacturer or fabricator awaiting transformation into some other product.

The focus of the examination of the branch's commodity lending area is on the lending policy and the control exercised over the collateral. The policy should address under what circumstances and conditions commodity loans will be made, particularly whether the branch will grant loans to finance a speculative position in a commodity. For secured loans, collateral margin requirements should be included in the policy.

Control of the collateral is important. Generally, the commodity will be held in a bonded warehouse, bank, or other depository institution. The branch should control title to the commodity. Because commodity markets can become volatile, collateral positions should be monitored frequently for compliance with the policy.

Securities Broker and Dealer Loans Examination Objectives

Effective date July 1997

Section 3120.2

- To determine if policies, practices, procedures, objectives, and internal controls regarding securities broker and dealer loans are adequate.
- 2. To determine if branch officers are operating in conformance with established guidelines.
- 3. To evaluate the adequacy of collateral, credit quality, and collectibility.
- To determine the scope and adequacy of the audit function.
- 5. To determine compliance with applicable laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Securities Broker and Dealer Loans

Examination Procedures

Effective date July 1997

Section 3120.3

- If selected for implementation, complete or update the Internal Control Questionnaire for this area.
- Based on the evaluation of internal controls and of the work performed by internal/ external auditors, ascertain the scope of the examination.
- Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Additionally, obtain a listing of any deficiencies noted in the latest review by internal/external auditors and determine if corrections have been accomplished.
- 4. Request the branch to supply:
 - a. Schedule of approved lines for each dealer, including outstanding balances.
 - b. Delinquent interest billings and date billed amount of past due interest.
- Obtain a trial balance of all dealer accounts and:
 - a. Verify balances to departmental controls and the general ledger.
 - Review reconciling items for reasonableness.
- Using an appropriate sampling technique, select borrowers to be reviewed.
- 7. Using the trial balance, transcribe the following information for each borrower selected onto the credit line cards:
 - a. Total outstanding liability.
 - b. Amount of approved line.
- Obtain from the appropriate examiner the following schedules, if applicable to this area:
 - a. Past due loans.
 - b. Loan commitments and other contingent liabilities.
 - c. Miscellaneous loan debit and credit suspense accounts.
 - d. Loans considered problem loans by management.
 - e. Each officer's current lending authority.
 - f. Current interest rate structure.
 - g. Any useful information obtained from the review of the minutes of the loan committee or any similar committee.
 - Reports furnished to the loan and discount committee or any similar committee.

- i. Reports furnished to the head office.
- j. Loans classified during the preceding examination.
- k. A listing of loans charged off since the preceding examination.
- 9. Review the information received and perform the following:
 - a. For miscellaneous loan debit and credit suspense accounts:
 - Discuss with management any large or old items.
 - Perform additional procedures as deemed appropriate.
 - For loans classified during the previous examination, determine disposition of loans so classified by transcribing:
 - Current balances and payment status, or
 - Date loan was repaid and sources of payment.
 - For loan commitments and other contingent liabilities, analyze if:
 - The borrower has been advised of the contingent liability.
 - The combined amounts of the current loan balance and the commitments or contingent liabilities exceed the cutoff.
 - d. Select loans that require in-depth review based on information derived when performing the above steps.
- 10. For those loans selected in step 6 above and for any other loans selected while performing the above steps, transcribe the following information from the branch's collateral record onto the credit line sheets:
 - a. A list of collateral held, including date of entry and amount advanced.
 - b. A brief summary of the agreement between the branch and the dealer.
 - c. Evidence that the proper documentation is in place.
 - d. Details of any other collateral held.
- 11. The examiner should be aware that certain stock-secured transactions with and for brokers and dealers are exempt from the margin restrictions of Regulation U. Refer to the regulation, which can be found in the Federal Reserve Regulatory Service, for a complete description of such transactions that include the following:

- a. Temporary advances to finance cash transactions.
- b. Securities in transit or transfer.
- c. Day loans.
- d. Temporary financing of distributions.
- e. Arbitrage transactions.
- f. Credit extended pursuant to hypothecation.
- g. Emergency credit.
- h. Loans to specialists.
- i. Loans to odd-lot dealers.
- i. Loans to OTC market makers.
- k. Loans to third-market makers.
- l. Loans to block positioners.
- m. Loans for capital contributions.
- 12. At this point, the examiner needs to decide whether further examination and testing is needed. If further work is warranted, refer to the audit guidelines. After reviewing the audit guidelines, proceed to step 13.
- Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
 - a. Delinquent loans.

- b. Loans on which collateral documentation is deficient.
- Recommended corrective action when policies, practices, or procedures are deficient
- d. Other matters regarding the condition of the department.
- 14. Prepare appropriate comments for the workpapers and the examiner-in-charge stating your findings with regard to:
 - a. The adequacy of written policies relating to securities broker and dealer loans.
 - The manner in which branch officers are conforming with established policy.
 - Schedules applicable to the department that were discovered to be incorrect or incomplete.
 - d. The competence of departmental management.
 - e. Internal control deficiencies or exceptions.
 - f. Other matters of significance.
- Update the workpapers with any information that will facilitate future examinations.

Securities Broker and Dealer Loans Internal Control Questionnaire

Effective date July 1997

Section 3120.4

Review the branch's internal control, policies, practices, and procedures for making and servicing loans. The branch's system should be documented in a complete and concise manner and should include, *where appropriate*, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

POLICIES

- Has a policy been adopted specifically addressing securities broker and dealer loans that:
 - a. Establishes standards for determining broker and dealer credit lines?
 - b. Establishes minimum standards for documentation?
- 2. Are such loan policies reviewed at least annually to determine if they are compatible with changing market conditions?
- 3. Is a daily record maintained summarizing loan transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger account entries?
- 4. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
- 5. Is an exception report produced and reviewed by operating management that encompasses extensions, renewals, or any factors that would result in a change in customer account status?
- 6. Do customer account records clearly indicate accounts that have been renewed or extended?

LOAN INTEREST

- 7. Is the preparation and posting of interest records performed and reviewed by appropriate personnel?
- 8. Are any independent interest computations made and compared or adequately tested to initial interest records by appropriate personnel?

COLLATERAL

- Are multi-copy, prenumbered records maintained that:
 - a. Detail the complete description of collateral pledged?
 - b. Are computer generated or typed?
- 10. Are receipts issued to customers covering each item of negotiable collateral deposited?
- 11. If applicable, are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
- 12. Are appropriate steps with regard to Regulation T being considered in granting broker and dealer loans?
- 13. Concerning commodity lending:
 - a. Is control for the collateral satisfactory, i.e., stored in the branch's vault, another bank, or a bonded warehouse?
 - b. If collateral is not stored within the branch, are procedures in effect to ascertain the authenticity of the collateral?
 - c. Does the branch have a documented and recorded security interest in the proceeds of the future sale or disposition of the commodity and the existing collateral position?
 - d. Do credit files document that the financed positions are and remain fully hedged?
- 14. Concerning loans to commodity brokers and dealers:
 - a. Does the branch maintain a list of the major customer accounts of the brokers or dealers to whom it lends? If so, is the list updated on a periodic basis?
 - b. Is the branch aware of the broker/ dealer's policy on margin requirements and the basis for valuing contracts for margin purposes, i.e., pricing spot versus future?
 - c. Does the branch attempt to ascertain whether the positions of the broker/ dealer's clients that are indirectly financed by branch loans remain fully hedged?

CONCLUSION

- 15. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 16. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Securities Broker and Dealer Loans Audit Guidelines

Effective date July 1997

Section 3120.5

- 1. Verify the accuracy of the trial balance.
- Test reconciling items to the extent considered necessary.
- 3. Using an appropriate sampling technique, select broker and dealer loans and:
 - a. Prepare and mail confirmation forms to dealers (information confirmed should include the loan balance and date of entry).
 - After a reasonable time period, mail second requests.
 - c. Follow up on any no-replies or exceptions, and resolve differences.
 - d. Obtain a list of the most recent broker and dealer interest billings and check calculation of interest report.

- Determine whether interest payments are delinquent and trace to inclusion in delinquency report.
- f. Determine that appropriate action has been taken to bring delinquent accounts to a current status.
- 4. Review collateral records and:
 - a. Determine the reason for differences between the branch's collateral records and the actual items held by the branch.
 - b. Investigate other differences to the extent considered necessary.

Effective date July 1997

This section addresses securities activities in the broadest meaning of the term. It is divided into three sections: Investment Securities, Trading Securities, and Other, which includes resale and repurchase transactions.

INVESTMENT SECURITIES

Since January 1, 1994, investment securities activities of branches are subject to FASB Statement No. 115 (Accounting for Certain Investments in Debt and Equity Securities). Under this standard, all branches are required to segregate their investment securities portfolios into three categories: (1) held-to-maturity, (2) available-for-sale, and (3) trading securities. The held-to-maturity category replaces the former held-for-investment category. The available-for-sale category is new, and the trading category is the same as before.

Held-to-maturity (HTM) securities are debt securities that the branch has both the intent and ability to hold until maturity. The branch will continue to report HTM securities at amortized cost.

Available-for-sale (AFS) securities are defined as debt or equity securities for which the branch does not have the positive intent and ability to hold to maturity, yet does not intend to trade actively as a part of its trading account. AFS securities transactions must be reported at fair value with any unrealized gains and losses reported directly as a separate component of equity capital. Thus, unrealized changes in these securities' value will have no effect on the reported earnings of the branch.

Trading securities are those debt and equity securities that a branch buys and holds principally for the purpose of selling in the near term. Trading securities will continue to be reported at fair market value with unrealized gains or losses reported directly in the income statement as a part of the branch's earnings.

This section will deal only with investment securities, or those categorized as HTM and AFS. A complete discussion of trading securities is contained in the Federal Reserve's *Trad*-

ing Activities Manual. Additional reference material includes:

- FFIEC's Supervisory Policy Statement on Securities Activities as of January 10, 1992.
- SR 93-69—"Risk Management and Internal Controls for Trading Activities of Banking Organizations."
- SR 95-17—"Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities."

The rationale behind FASB creating the AFS category and allowing institutions to report AFS securities at fair value is that it presents a more accurate and realistic picture of an institution's financial condition. The inclusion of net unrealized gains and losses with Tier 1 capital provides incentives to institutions to hold securities that have depreciated or appreciated in value, thereby reducing market volatility. However, although market volatility is reduced, bank's capital ratios are subject to increased volatility since their assets will be marked-to market while liabilities remain at book value.

In addition to any restrictions imposed by state law or regulation, under Section 7(c)(2) of the International Banking Act of 1978, all branches may only hold the types of investment securities that may be held by national banks and state member banks. See 12 USC 24(7); 12 CFR Part 1. State-licensed branches, additionally, may only hold those types of investment securities permitted under state law. It should be noted that branches must obtain Federal Reserve approval, before commencing commodity or equity-linked transactions. See 12 CFR 208.128 (made applicable to branches by 12 USC 3105(c)(2)).

For branches, investment securities include U.S. government obligations and certain domestic corporate debt securities; as well as various federal agency bonds; state, county, and municipal issues; special revenue bonds; and industrial revenue bonds. Securities included in the investment account should provide a reasonable rate of return as well as provide the necessary liquidity the branch requires. Accordingly, an investment account should contain some securities that may be quickly converted into cash by sale or by maturity. Hence, liquidity and marketability are of the utmost importance. A bond

is a liquid asset if its maturity is short and if there is reasonable assurance that it will be paid at maturity. It is marketable if it may be sold quickly at a price commensurate with its yield and quality. The highest quality bonds have either or both of those two desirable qualities.

Occasionally, it may be difficult to distinguish between a loan and a security. Loans generally result from direct negotiations between a borrower and a lender. A branch may refuse to grant a loan unless it and the borrower can agree to terms. A security, on the other hand, is usually acquired through a third party, a broker or dealer in securities. Most securities have standardized terms, which can be compared to the terms of other market offerings. Because the terms of most loans do not lend themselves to such comparison, the average investor may not accept the terms of the lending arrangement. Thus, an individual loan cannot be regarded as a readily marketable security.

An interesting hybrid between a security and a loan is a private placement. A private placement is a security transaction whereby the issuer did not involve any "public offering" but rather offered the securities privately. The securities are not reviewed by the SEC, and are offered and sold only to those parties who the issuer believes are (1) sufficiently experienced to evaluate merits and risks of the investment, or (2) able to bear the risk of the investment. Through negotiation, both parties may tailor the offering to meet their needs. The issuer saves securities registration costs and the investor makes an investment for a specified length of time at a stated rate of return. Both investor and issuer complete the transaction privately without being subject to regulatory and public scrutiny. The major disadvantage of private placements is the lack of a secondary market, and therefore it may be highly illiquid. Although private placements have many characteristics of loans, for regulatory reporting purposes they are considered securities.

INVESTMENT POLICY

The branch should have an investment policy, which was developed in conjunction with and approved by its head office, to control and monitor the branch's investment activities. This policy should include guidelines for personnel involved in securities activities.

The basic objectives of a sound investment policy are the same for all financial institutions but the emphasis placed on each objective will vary, according to the individual branch's needs. The basic objectives include:

- · Minimizing risks.
- Generating a favorable return on investments, without undue compromise of the other objectives.
- Providing for and managing liquidity.
- · Meeting any applicable pledge requirements.
- · Temporary use of excess funds.

The investment policy must encompass more than a philosophical description of objectives. If policy development is delegated to local branch management, the examiner should verify that head office management has reviewed or is aware of the policy and the branch's level of compliance.

TYPES OF INVESTMENT SECURITIES

The investment policy should include guidelines on the quality and quantity of each type of security to be held. Credit quality is of major importance.

U. S. government obligations are the highest quality investments and are the most readily marketable. They are riskless from a credit standpoint but are subject to price fluctuations because of changes in money market interest rates. Longer-term issues tend to fluctuate more widely than shorter-term issues. All things being equal, maturity, credit, etc., smaller coupon securities are more volatile than larger coupon securities.

Federal agency securities are also of very high quality. Similar investments that enjoy wide acceptance in the banking community are U.S. government guaranteed public housing authority issues. New housing authority and public housing authority notes or bonds generally provide the investor with tax exempt income and a full faith and credit guaranty of the U.S. government.

Other tax exempt bonds have varying levels of indirect U.S. government support. Pre-refunded

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or escrowed bonds are often fully and directly secured by obligations issued by or otherwise supported by the full faith and credit of the United States. Certain municipal housing bonds are partially payable from rental subsidies and/or mortgage credit insurance provided by federal agencies. Pools of partially guaranteed student loans are sometimes pledged for payment of municipal higher education bonds. There are numerous programs that provide federal backing for municipal bonds. Care must be taken to distinguish between those issues that are federally guaranteed and those that are not.

High quality municipal bonds frequently are desirable because of their tax exempt status. Many municipal bonds, however, possess an

unfavorable market aspect. Except for high quality issues of larger municipalities, municipal bonds often are not readily marketable and, as a result, may produce sizeable spreads between bid and ask prices. The spread may be so wide, it may cost the selling bank a sizeable portion of a year's interest.

BOND RATINGS

Monthly rating service publications are useful in determining the investment quality of municipal and corporate obligations. The standard bond rating symbols, as shown on the following page, are listed in the order of their credit quality.

Standard & Poor's	Moody's	Description			
Bank Quality Investments					
AAA	Aaa	Highest grade obligations.			
AA	Aa	High grade obligations			
A	A-1, A	Upper medium grade			
ВВВ	Baa-1, Baa	Medium grade, on the borderline between defi- nitely sound obligations and those containing predominantly speculative elements. Generally, the lowest quality bond that may qualify for bank investment.			
Speculative and Defaulted Issues (High Yield or Noninvestment Grade)					
BB	Ba	Lower medium grade with only minor investment characteristics.			
В	В	Low grade, default probable.			
Ccc, cc, c, D	Caa, Ca, C	Lowest rated class, may be in default, extremely poor material prospects.			
Provisional or Conditional Rating					
Rating-P	Con. (Rating)	Debt service requirements are largely dependent on reliable estimates as to future events.			

Although the analyses of major rating agencies are basically sound and updated frequently, it should be kept in mind that ratings are only evaluations of probabilities. In order to determine appropriate credit limits to a particular counterparty, bond ratings should be supplemented by the branch's own credit analysis of the issuer.

Sub-investment-quality securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes securities in grades below the four highest grades and unrated securities of equivalent quality, defaulted securities and sub-investment-quality stocks. As noted in the following chart, securities in grades below the four highest grades and unrated securities of equivalent quality will be valued at market price. The market value will be classified substandard, and the depreciation will be classified doubtful. Depreciation in defaulted securities and sub-investment-quality stocks will generally be classified loss; market value will be classified substandard.

SECURITY CLASSIFICATIONS

Type of Security	Classification		
	Substandard	Doubtful	Loss
Investment-quality	XXX	XXX	XXX
Sub-investment-quality, except—	Market Value	Market Depreciation	XXX
Sub-investment-quality, municipal general obligations	Book Value	XXX	XXX
Defaulted securities and sub-investment-quality stocks, except—	Market Value	XXX	Market Depreciation
Defaulted municipal general obligations:			
Interim	XXX	Book Value	XXX
Final, i.e., when market is reestablished	l Market Value	XXX	Market Depreciation

As a matter of policy, an institution should not acquire securities until it has assessed the creditworthiness of the issuer and determined that the risk exposure conforms with its policies. At a minimum, the examiner should expect such a policy to require credit reviews on all transactions before purchase, annual internal credit reviews, and more frequent credit updates on all nonrated issues, municipal obligations with a credit rating that has declined, special revenue and other debt obligations with limited or no marketability, speculative and defaulted issues,

and stocks acquired through DPC transactions. Credit analysis is always necessary to determine if an investment is appropriate for the branch to own. According to Federal regulation (12 CFR, Section 1.8) it is incumbent upon management to demonstrate that it has exercised prudence in acquiring all investment securities.

The examiner should be mindful, however, that as part of a larger organization, the branch may operate soundly outside of the parameters normally considered acceptable due to its unique role within the FBO's network. When tradi-

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tional liquidity analysis results in unsatisfactory findings, the examiner should discuss with management the influence of the branch's relationships with related offices.

Policy guidelines for risk diversification should be formulated in conformity with legal and prudent investment restrictions. Concentrations resulting from the obligations of a single or related issuer, credit ratings, geographic and type distribution may all be compatible with sound investment policy. In many cases, concentrations would not be considered unwarranted but, in all cases, it is essential that investment concentrations be monitored at the head office level.

The investment policy should also take into consideration the applicable federal and state income tax laws. Finally, the investment portfolio should be reviewed at least annually by head office management and quarterly by senior officers of the branch. Sufficient analytical data must be provided to allow head office management to make an informed judgment of the investment policy's effectiveness. Such reviews should consider the information discussed in this section and the current market value of the portfolio.

Management should maintain clear lines of authority and responsibility for acquiring securities and managing risk. This includes setting appropriate limits on risk taking, creating adequate systems for measuring risk, providing effective internal controls, and implementing a comprehensive risk reporting and risk management review process.

TRADING SECURITIES

The following section deals with securities portfolio trading but does not include derivativerelated activity. For an in-depth discussion of derivative-related activity, refer to the Federal Reserve's *Trading Activities Manual*.

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which, when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the branch's income and a filing of false regulatory reports. It is an unsafe

and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards that are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts must be periodically marked-to-market with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the branch.

Covered Calls

The writing of covered calls is an option strategy that, for a fee, grants the buyer of the call option the right, but not the obligation to purchase a security owned by the option writer at a pre-determined price before a specified future date. The option fee¹ received by the writing (selling) depository institution provides income and has the effect of increasing the effective yield on the portfolio asset "covering" the call.

Covered call programs have been promoted as hedging strategies because the fee received by the writer can be used to offset a limited amount of potential loss in the price of the underlying security. If interest rates rise, the call option fee can be used to partially offset the decline in the market value of a fixed rate security or the increased cost of market rate liabilities used to carry the security. However, there is no assurance that an option fee will completely offset the price decline on the security or the increased cost of liabilities and the resulting reduced spread between the institution's return on assets and funding costs.

As a practical matter, the gain on a security covered by a written call is limited to the amount of the difference between the carrying value of the security and the strike price at which the security will be called away. The potential for losses on the covered security is not similarly limited. In an effort to obtain higher yields, some portfolio managers have mistakenly relied on the theoretical hedging benefits of

Recognition of option fee income should be deferred until the option is exercised or expires. The covered call writer shall value the option at the lower of cost or market value at each report date.

covered call writing, and have purchased extended maturity U.S. government or Federal agency securities. This practice can significantly increase risks taken by the branch by contributing to a maturity mismatch between its assets and its funding.

Institutions should only initiate a covered call program for securities when head office and branch management have specifically approved a policy permitting this activity. This policy must set forth specific procedures for controlling covered call strategies, including recordkeeping, reporting, and review of activity, as well as providing for appropriate management information systems to report the results. Since the purchaser of the call acquires the ability to call the security away from the institution that writes the option, the ability of that institution to continue to hold the security rests with an outside party. Securities held to maturity against which call options have been written should therefore be redesignated as available for sale and reported at fair value. However, when the option contract requires the writer to deliver held-to-maturity securities, or when management has a pattern of practice of delivering heldto-maturity securities when called, management's intent to hold other securities to maturity may be called into question.

However, if an option contract requires the writer to settle in cash, rather than delivering an investment portfolio security, the institution writing the option maintains the ability to hold the security and, thus, the security may be reported as held-to-maturity. In this case, the option must still be reported at fair value.

Adjusted Trading

Adjusted trading is a practice involving the sale of a security to a broker or dealer at a price above the prevailing market value and the simultaneous purchase and booking of a different security, frequently a lower grade issue or one with a longer maturity, at a price greater than its market value. Thus, the broker or dealer is reimbursed for losses on the purchase from the institution and ensured a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive reported value for the newly acquired security. Consequently, such transactions are prohibited and may be in violation of 18 USC

sections 1001-False Statements or Entries and 1005-False Entries.

Coupon Stripping

Coupon stripping involves detaching unmatured coupons from securities and selling either the coupons or the remaining stripped security. Such transactions are often motivated by anxiety for immediate income recognition or by tax considerations. This practice significantly diminishes the worth, marketability, and liquidity of the securities.

U.S. government obligations are the most common type of security used for coupon stripping. Corporate or municipal issues may be used but are not viewed as attractive alternatives because of credit risk and early redemption features.

The Internal Revenue Service has ruled that the proceeds from the sale of unmatured coupons constitute ordinary income and are included in the taxable income for the year in which the sale occurred. A branch can increase current period taxable income to utilize a prior year's tax loss carry-forward by selling all or a portion of the unmatured coupons of their securities. Similarly, an ex-coupon security may be sold at its discounted value. The difference between the sale proceeds and the cost basis of the security is recognized as a current period tax loss.

There are a limited number of dealers that participate in wholesale and retail trading and reoffering of detached coupons and ex-coupon securities. That activity is generally viewed as inappropriate for branch dealers; the marketability and liquidity shortcomings attendant with either the coupons or the securities result in uncertain suitability for customer purchase without complete customer disclosure and consent. Ex-coupon securities or stripped coupons are distinctly different from securities that have all the unmatured coupons attached. The ex-coupon security and resulting coupons generally:

- Have a diminished and uncertain market value and impaired practical liquidity.
- Are not, absent adequate customer disclosure, suitable for sale to customers or as repurchase agreement collateral with customers.
- Are not considered good delivery items by securities dealers.

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If a branch has engaged or elects to engage in such transactions, they must be reported as follows:

- The book value must be allocated between the principal portion and the coupons at the time the security is divided. This allocation will be based upon the present value of each component (principal and coupons) at the time of sale using the yield to maturity at the time the security was purchased as the discount rate.
- The profit or loss on the portion sold must be recognized during the period in which the sale occurred as other income or other expense. It will be the difference between that portion of the book value, allocated as above to the portion sold, and the actual selling price of that portion. The portion retained will be carried on the books of the branch at its allocated portion of the book value. Detached coupons or principal portions held by a branch, either as a result of purchase or of stripping securities held for its own account, will be reported as other notes, bonds and debentures, and not as U.S. Treasury securities, obligations of other U.S. government agencies and corporations, or obligations of states and political subdivisions in the United States.

Special Guidance on Mortgage-Backed Products

Some mortgage-backed products exhibit considerably more price volatility than mortgages. Some mortgage pass-through securities can expose investors to significant risk of loss if not managed in a safe and sound manner. This price volatility is caused in part by the uncertain cash flows that result from changes in the prepayment rates of the underlying mortgages.

In addition, because these products are complex, a high degree of technical expertise is required to understand how their prices and cash flows may behave in various interest rate and prepayment environments. Moreover, because the secondary market for some of these products can be relatively thin, they may be difficult to liquidate should the need arise. Finally, there is additional uncertainty because new variants of these instruments continue to be introduced and their price performance under varying market and economic conditions has not been tested.

General Guidance

Under the FFIEC policy statement, the banking agencies call for special management of mortgage-backed products. A general principle underlying this policy is that mortgage-backed products possessing average life or price volatility in excess of a benchmark fixed rate 30-year mortgage-backed pass-through security are "high-risk mortgage securities" and are not suitable investments. All high-risk mortgage securities, defined later in this section, acquired by depository institutions after February 10, 1992, must be carried in the institution's trading account or as assets available for sale. Mortgagebacked products that do not meet the definition of a high-risk mortgage security at the time of purchase may be reported as held to maturity, available for sale, or held for trading, as appropriate. Branches must ascertain no less frequently than annually whether such products have become high-risk mortgage securities.

Branches generally should hold mortgagebacked products that meet the definition of a high-risk mortgage security only to reduce interest rate risk in accordance with safe and sound practices.² Furthermore, depository institutions that purchase high-risk mortgage securities must demonstrate that they understand and are effectively managing the risks associated with these instruments. Levels of activity involving highrisk mortgage securities should be reasonably related to a branch's capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls must be in place and the branch must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities in an environment of changing price and maturity expectations.

Prior to taking a position in any high-risk mortgage security, branch management should conduct an analysis to ensure that the position will reduce the overall interest rate risk. Liquid-

^{2.} Notwithstanding the provisions of the Board's supervisory policy generally requiring that high-risk mortgage securities be used only for the purpose of reducing interest rate risk, this supervisory policy is not meant to preclude an institution with strong capital and earnings and adequate liquidity that has a closely supervised trading department from acquiring high-risk mortgage securities for trading purposes. The trading department must operate in conformance with well-developed policies, procedures, and internal controls, including detailed plans prescribing specific position limits and control arrangements for enforcing these limits.

ity and price volatility of these products also should be considered prior to purchasing them. Circumstances in which the purchase or retention of high-risk mortgage securities is deemed by the appropriate regulatory authority to be contrary to safe and sound practices for depository institutions will result in criticism by examiners, who may require the orderly divestiture of high-risk mortgage securities. Purchases of high-risk mortgage securities prior to February 10, 1992, generally will be reviewed in accordance with previously-existing supervisory policies.

Securities and other products, whether carried on or off the balance sheet (such as CMO swaps, but excluding servicing assets), having risk characteristics similar to high-risk mortgage securities will be subject to the same supervisory treatment as high-risk mortgage securities.

Long-term zero coupon bonds also exhibit significant price volatility and may expose an institution to considerable risk. Disproportionately large holdings of these instruments may be considered an imprudent investment practice, which will be subject to criticism by examiners. In such instances, examiners may seek the orderly disposal of some or all of these securities. Assets slated for disposal are to be reported as assets available for sale at their market value.

Definition of "High-Risk Mortgage Security"

In general, any mortgage-backed product that exhibits greater price volatility than a benchmark fixed rate thirty-year mortgage-backed pass-through security will be deemed to be high risk. For purposes of the FFIEC policy statement, a "high-risk mortgage security" is defined as any mortgage-backed product that at the time of purchase, or at a subsequent testing date, meets any of the following tests. In general, a mortgage derivative product that does not meet any of the three tests below will be considered to be a "nonhigh-risk mortgage security."

 Average Life Test. The mortgage-backed product has an expected weighted average life greater than 10.0 years. Average Life Sensitivity Test. The expected weighted average life of the mortgage-backed product:

- Extends by more than 4.0 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, or
- Shortens by more than 6.0 years, assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points.
- Price Sensitivity Test. The estimated change in the price of the mortgage-backed product is more than 17 percent, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.⁴

In applying any of the above tests, all of the underlying assumptions (including prepayment assumptions) for the underlying collateral must be reasonable. All of the assumptions underlying the analysis must be available for examiner review. For example, if an institution's prepayment assumptions differ significantly from the median prepayment assumptions of several major dealers as selected by examiners, the examiners may use these median prepayment assumptions in determining if a particular mortgage backed product is high risk.

The above tests may be adjusted to consider significant movements in market interest rates, to fairly measure the risk characteristics of new mortgage-backed products, and to take such action that is deemed appropriate to prevent circumvention of the definition of a high-risk mortgage security and other such standards.

Generally, a CMO floating-rate debt class will not be subject to the average life and average life sensitivity tests described above if it bears a rate that, at the time of purchase or at a

When the characteristics of a mortgage derivative product are such that the first two tests cannot be applied (such as with IOs), the mortgage derivative product remains subject to the third test.

^{4.} When performing the price sensitivity test, the same prepayment assumptions and same cash flows that were used to estimate average life sensitivity must be used. The only additional assumption is the discount rate assumption.

First, assume that the discount rate for the security equals the yield on a comparable average life U.S. Treasury security plus a constant spread. Then, calculate the spread over Treasury rates from the bid side of the market for the mortgage derivative product. Finally, assume the spread remains constant when the Treasury curve shifts up or down 300 basis points. Discounting the aforementioned cash flows by their respective discount rates estimates a price in the plus and minus 300 basis point environments.

The initial price will be determined by the offer side of the market and used as the base price from which the 17 percent price sensitivity test will be measured.

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subsequent testing date, is below the contractual cap on the instrument. (An institution may purchase interest rate contracts that effectively uncap the instrument.) For purposes of this policy statement, a CMO floating-rate debt class is a debt class whose rate adjusts at least annually on a one-for-one basis with the debt class's index. The index must be a conventional, widely-used market interest rate index such as the London Interbank Offered Rate (LIBOR). Inverse floating rate debt classes are not included in the definition of a floating rate debt class.

Supervisory Policy for Mortgage-Backed Products

Prior to purchase, a branch must determine whether a mortgage-backed product is highrisk. A prospectus supplement or other supporting analysis that fully details the cash flows covering each of the securities held by the institution should be obtained and analyzed prior to purchase and retained for examiner review. In any event, a prospectus supplement should be obtained as soon as it becomes available.

Nonhigh-Risk Mortgage Securities

Mortgage-backed products that do not meet the definition of high-risk mortgage securities, at the time of purchase, should be reported as held to maturity, available for sale, or held for trading, as appropriate. Branches must ascertain and document prior to purchase and no less frequently than annually thereafter that nonhighrisk mortgage securities that are held to maturity remain outside the high-risk category. If a branch is unable to make these determinations through internal analysis, it must use information derived from a source that is independent of the party from whom the product is being purchased. Standard industry calculators used in the mortgage-related securities market place are acceptable and are considered independent sources. In order to rely on such independent analysis, institutions are responsible for ensuring that the assumptions underlying the analysis and the resulting calculation are reasonable. Such documentation will be subject to examiner review.

A mortgage-backed product that was not a high-risk mortgage security when it was purchased as an investment may later fall into the high-risk category. When this occurs, the branch may continue to designate the mortgage-backed product as held to maturity, providing that management still maintains the positive intent and ability to hold the security to maturity. Furthermore, examiners should consider any unrecognized net depreciation in held-to-maturity high-risk securities when reviewing earnings and evaluating liquidity risk.

Once a mortgage-backed product has been designated as high-risk, it may be redesignated as nonhigh-risk only if, at the end of two consecutive quarters, it does not meet the definition of a high-risk mortgage security. Upon redesignation as a nonhigh-risk security, it does not need to be tested for another year.

High-Risk Mortgage Securities

A branch may, generally, only acquire a highrisk mortgage backed product to reduce its overall interest rate risk. (Branches meeting the previously mentioned guidance regarding the use of these securities in a trading account may also purchase these securities for trading purposes.) A branch that has acquired high-risk mortgage securities to reduce interest rate risk needs to frequently assess its interest rate risk position and the performance of these securities. Since interest rate positions constantly change, a branch may determine that these high-risk mortgage securities no longer reduce interest rate risk. Therefore, mortgage backed products that are high-risk when acquired shall not be reported as held-to-maturity securities at amortized cost.

In appropriate circumstances, examiners may seek the orderly divestiture of high-risk mortgage securities that do not reduce interest rate risk. Appropriate circumstances are those in which the examiner determines that continued ownership of high-risk mortgage securities represents an undue safety and soundness risk to the branch. This risk can arise from the size of the branch's holdings of high-risk mortgage securities in relation to its earnings and head office capital, management's inability to demonstrate an understanding of the nature of the risks inherent in the securities, the absence of internal monitoring systems and other internal controls to appropriately measure the market and cash flow risks of these securities, management's inability to prudently manage its overall interest rate risk, or similar factors.

A branch that owns or plans to acquire high-risk mortgage securities must have a monitoring and reporting system in place to evaluate the expected and actual performance of such securities. The institution must conduct an analysis that shows that the proposed acquisition of a high-risk mortgage security will reduce the institution's overall interest rate risk. Subsequent to purchase, the branch must evaluate at least quarterly whether this high-risk mortgage security has actually reduced interest rate risk.

The branch's analyses performed prior to the purchase of high-risk mortgage securities and subsequently thereafter must be fully documented and will be subject to examiner review. This review will include an analysis of all assumptions used by management regarding the interest rate risk associated with the branch's assets, liabilities and off-balance sheet positions. Analyses performed and records constructed to justify purchases on a post-acquisition basis are unacceptable and will be subject to examiner criticism. Reliance on analyses and documentation obtained from a securities dealer or other outside party without internal analyses by the institution are unacceptable and reliance on such third-party analyses will be subject to examiner criticism.

Management should also maintain documentation demonstrating that it took reasonable steps to assure that the prices paid for high-risk mortgage securities represented fair market value. Generally, price quotes should be obtained from at least two brokers prior to executing a trade. If, because of the unique or proprietary nature of the transaction or product, or for other legitimate reasons, price quotes cannot be obtained from more than one broker, management should document the reasons for not obtaining such quotes.

In addition, a branch that owns high-risk mortgage securities must demonstrate that it has established the following:

- A head office approved portfolio policy which addresses the goals and objectives the branch expects to achieve through its securities activities, including interest rate risk reduction objectives with respect to high-risk mortgage securities;
- Limits on the amounts of funds that may be committed to high-risk mortgage securities;
- Specific financial officer responsibility for and authority over securities activities involving high-risk mortgage securities;

- Adequate information systems;
- Procedures for periodic evaluation of highrisk mortgage securities and their actual performance in reducing interest rate risk; and
- Appropriate internal controls.

The branch's senior management should regularly (at least quarterly) review all high-risk mortgage securities to determine whether these instruments are adequately satisfying the interest rate risk reduction objectives set forth in the portfolio policy. The branch's senior management should be fully knowledgeable about the risks associated with prepayments and their subsequent impact on its high-risk mortgage securities. Failure to comply with this policy will be viewed as an unsafe and unsound practice.

OTHER MORTGAGE-BACKED PRODUCTS

There are advantages and disadvantages in owning these products. A branch must consider the liquidity, marketability, pledgeability, and price volatility of each of these products before investing in them. It may be unsuitable for a branch to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals, and zero coupon bonds, which fluctuate greatly in price.

Stripped Mortgage-Backed Securities

Stripped mortgage backed securities (SMBS) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100 percent of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100 percent of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline, while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the

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interest rate risk associated with mortgages and similar instruments held by a branch. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO, the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for all branches. SMBS, however, may be appropriate holdings for branches that have highly sophisticated and well-managed securities portfolios, mortgage portfolios, or mortgage banking functions. In such branches, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by head office management and their terms should be vigorously enforced.

Some branches may account for their SMBS holdings in accordance with Financial Accounting Standards Board Statement Number 91 (FASB No. 91), which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other branches may account for their SMBS holdings at market value or the lower of cost or market value.

Asset-Backed Securities Residuals

Residuals are the excess of cashflows from asset-backed securities (ABS) transactions after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically, a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the yield on these instruments is inversely

related to their effectiveness as a risk management vehicle. In other words, the highest yielding ABS residuals have limited risk management value due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cashflows difficult. Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher yielding interests, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Holdings of ABS residuals should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as Other Assets on regulatory reports.

Other Zero Coupon or Stripped Products

The interest and/or principal portions of U.S. government obligations are sometimes sold in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATS or TIGRs. Original issue discount bonds (OIDs) have also been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility. Accordingly, disproportionately large, long-maturity holdings (in relation to the total portfolio) of zero coupon securities may be unsuitable for investment holdings for financial institutions.

STRUCTURED NOTES

This sub-section highlights the growing use of structured notes by banking organizations and the need for examiners to ensure that banks that hold these instruments do so according to their own investment policies and procedures and with a full understanding of the risks and price sensitivity of these instruments under a broad

range of market conditions. Some of these instruments can expose investors to significant losses as interest rates, foreign exchange rates, and other market indices change. Accordingly, examiners should be mindful of these securities, whether they are used in a branch's trading, investment, or trust activities.

Structured notes, many of which are issued by U.S. government agencies, government-sponsored entities, and other organizations with high credit ratings, are debt securities whose cashflows are dependent on one or more indices in ways that create risk characteristics of forwards or options. They tend to have medium term maturities and reflect a wide variety of cashflow characteristics that can be tailored to the needs of individual investors.

As previously noted, the federal bank regulatory agencies have established price and effective maturity standards for mortgage-backed products based on specified scenarios. Institutions should ensure that they meet these regulatory requirements and should employ similar techniques in controlling the exposures of structured notes. The scenarios specified for assessing the market risk of these products should be sufficiently rigorous to capture all meaningful effects of any options. For example, in assessing interest rate risk, scenarios such as 100, 200 and 300 basis point parallel shifts in yield curves should be considered as well as appropriate non-parallel shifts in structure to evaluate potential basis, volatility and yield curve risks.

Structured notes may offer certain advantages over other financial instruments used to manage market risk. In particular, they may reduce counterparty credit risk, offer operating efficiencies and lower transaction costs, require fewer transactions, and address more specifically an institution's risk exposures. Risk to principal is typically small. Accordingly, when they are analyzed and managed properly, structured notes can be acceptable investments and trading products for banks.

Structured notes, however, can also have characteristics that cause them to be inappropriate holdings for many institutions. They can have substantial price sensitivity; they can be complex and difficult to evaluate; and they may also reflect high amounts of leverage relative to fixed income instruments with comparable face values. Their customized features and embedded options may also make them difficult to price and can reduce their liquidity. Consequently, branches considering the purchase of

structured notes should determine whether these factors are compatible with their investment horizons and with their overall portfolio strategies.

There are a wide variety of structured notes, with names such as single- or multi-index floaters, inverse floaters, index-amortizing notes, step-up bonds, and range bonds. These simple, though sometimes cryptic, labels can belie the potential complexity of these notes and their possibly volatile and unpredictable cashflows, which can involve both principal and interest payments. Some notes employ "trigger levels," at which cashflows can change significantly, or caps or floors, which can also substantially affect their price behavior.

The critical factor for examiners to consider is the ability of management to understand the risks inherent in these instruments and to manage the market risks of their institution in a satisfactory manner. Therefore, examiners should evaluate the appropriateness of these securities branch-by-branch, with a knowledge of management's expertise in evaluating such instruments, the quality of the institution's relevant information systems, and the nature of its overall exposure to market risk. This evaluation may include a review of the institution's ability to conduct stress tests. Failure of management to understand adequately the dimensions of the risks in these and similar financial products can constitute an unsafe and unsound practice for

When making investment decisions, some institutions may focus only on the low credit risk and favorable yields of these notes and either overlook or underestimate their market and liquidity risks. Consequently, where these notes are material, examiners should discuss their role in the institution's risk management process and assess management's recognition of their potential volatility.

OTHER

Resale and Repurchase Agreement Activities (REPOS)

Repos typically involve short-term U.S. government securities purchased for the branch's own account or acquired under an agreement to resell and then sold under the counterparties agreement to repurchase. The rate of interest received and paid is generally dictated by prevailing

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market rates. Profits are based on a small spread between interest earned and interest paid. Since both the profit margin and inherent risk are minimal, repos are generally used to satisfy a branch's short-term funding needs. A branch may attempt to improve profits by increasing the volume of such transactions by using the proceeds of completed transactions to finance an inventory of assets to be used in further repurchase arrangements. An alternative method of increasing profits is to increase the earnings yield of the instruments employed in these transactions by lowering the quality or by mismatching the maturity of the resale and repurchase agreements.

Risks inherent in repos should be controlled by policy guidelines that:

- · Establish account limits.
- Require approximately matched asset and liability maturities with guidelines for acceptable levels of asset and liability mismatches.
- Provide for reasonable collateral margin and valuation techniques.
- Subject the underlying securities of a resale agreement to periodic market valuation in order to determine market exposure.
- Mandate credit approvals for parties providing securities acquired under agreements to resell.
- Insist that characteristics of the money market instruments be compatible with the branch's own investment standards.

Other Issues for Examiner Consideration

This section contains several important issues examiners should consider when examining investment portfolios. It covers (1) transfers of low quality securities, (2) the selection of securities dealers, and (3) unsuitable investment practices.

Transfers of Low Quality Securities

Low quality securities, broadly defined, include depreciated or sub-investment grade securities of questionable quality. As with other poor quality assets, the transfer of such securities from the branch to another branch or financial institution may be made to avoid detection and classification during regulatory examinations.

These transfers may be accomplished through participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated entities. Examiners should be alert to situations where a branch's intention seems to be the concealment of low quality securities for the purpose of avoiding examination scrutiny and possible classification. Refer to the section on Credit Risk Management for further information. If situations are uncovered where it is determined that a transfer of securities was undertaken for legitimate reasons, the examiner should make certain that the securities have been properly recorded on the books of the acquiring branch at a reasonable or fair market value during the examination of that branch.

Selection of Securities Dealers

Speculative activity often occurs when an investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

It is common for investment portfolio managers to rely on the expertise and advice of a securities sales representative for recommendations of proposed investments, investment strategies, and the timing and pricing of securities transactions. Accordingly, it is important for branch management to know the securities firms and the personnel with whom it deals. An investment manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Branch management must review the dealer's financial statements and make a judgment about the ability of the dealer to honor its commitments. An inquiry into the general reputation of the dealer also is necessary.

Head office management should review and approve, or at least closely monitor, the list of securities firms with whom local branch management is authorized to do business. The following securities dealer selection standards are recommended but are not all inclusive. The dealer selection process should include:

 A consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current

financial data, annual reports, credit reports, etc.

- An inquiry into the dealer's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current customers of the securities dealer.
- An inquiry of appropriate state or federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel.
- An inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise.
- A determination of whether the branch has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) local and head office management is completely satisfied as to the creditworthiness of the securities dealer, (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by local and head office management for unsecured transactions and (3) at least two signatures are required for the sale/release of the security.

The process of managing relationships with securities dealers may affect the branch's code of ethics or conduct as it relates to employee activities. Specifically, the branch should consider prohibiting employees who are directly involved in purchasing and selling securities for the branch from conducting their own personal securities transactions with the same securities firm employed by the branch unless approved and under periodic review by local and head office management. Local and head office management may also wish to adopt a policy applicable to officers or employees, concerning the receipt of gratuities or travel expenses from approved dealer firms and their personnel.

Objectionable Investment Practices

Local and head office management is responsible for the prudent administration of branch investments in securities. An investment portfolio traditionally has been maintained to provide earnings, liquidity, and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of prudent investment activities and should be conducted in a securities trading account. Securities trading is viewed as an unsuitable activity when conducted in a branch's investment account. Securities trading should take place only in a closely supervised trading account. Acquisitions of the various forms of zero coupon, stripped obligations, and asset backed securities residuals will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a branch.

Securities Activities Examination Objectives

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Section 3130.2

- To determine if policies, practices, procedures, and internal controls regarding securities activities are adequate.
- 2. To determine if branch employees are operating in conformance with the established internal and supervisory guidelines.
- To determine the scope and adequacy of the internal and external audit functions as it relates to this area.
- 4. To determine the overall quality of the investment portfolio and how that quality relates to the soundness of the branch.

- 5. To determine if the branch is properly accounting for its securities.
- 6. To determine compliance with applicable laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Securities Activities Examination Procedures

Effective date July 1997

Section 3130.3

- If selected for implementation, complete or update the Internal Control Questionnaire for this section.
- Obtain a list of deficiencies noted in the previous examination report or by internal and external auditors, and determine if management has adequately addressed the deficiencies.
- Review the branch's investment policy and determine its adequacy. Ascertain whether the policy has been revised since the previous examination.
- 4. Review the reconcilement of the investment security trial balances to the general ledger.
- 5. Review management reports for accuracy and completeness.
- Review policies for classifying transactions as held to maturity, available for sale, or trading.
- 7. Review policies for classifying investment securities for credit or transfer risk.
- 8. Obtain a list of securities categorized as held to maturity, available for sale, and trading including:
 - a. Descriptions of securities held (par, book, and market values).
 - b. Names of issuers.
 - c. Issuers' countries of domicile.
 - d. Interest rates.
 - e. Pledged securities.
 - f. Internal credit rating.
- Reflecting the scope of the examination, select investments for review. If transaction volume permits, include all securities purchased since the prior examination in the population of items to be reviewed. Perform the following procedures for each investment:
 - a. For rated issues:
 - Compare the branch's internal ratings to the most recent published ratings.
 - · Verify CUSIP.
 - Check prospectus.
 - b. For unrated issues:
 - Perform a credit analysis to determine if the issues can be considered speculative.
 - c. If market prices are provided to the branch by an independent party (excludes affiliates and securities dealers selling investments to the branch) or if they are

- independently tested as a documented part of the branch's audit program, those prices should be accepted. If the independence of the prices cannot be established, test market values by reference to one of the following sources:
- Published quotations, if available.
- Appraisals by outside pricing services, if performed.
- If market prices are provided by the branch and cannot be verified by reference to published quotations or other sources, test those prices by using the comparative yield method to calculate approximate yield to maturity as follows:
 - Annual Interest
 - Par Value and Book Value
 - Number of Years to Maturity
 - Branch Provided Market Price + Par Value
- d. Compare the branch provided market price and the examiner calculated approximate yield to maturity to an independent, publicly offered yield or market price for a similar type of investment with similar rating, trading volume, and maturity or call characteristics.
- e. Investigate significant market value variances.
- 10. To the extent practical under the circumstances, perform a credit analysis of:
 - a. Selected obligors on securities purchased under agreements to resell.
 - b. All defaulted issues.
- Classify speculative and defaulted issues according to the following standards (except those securities with transfer risk where a more severe classification may be warranted):
 - a. The entire book value of speculative grade municipal general obligation securities, which are not in default, will be classified substandard. Market depreciation on other speculative issues should be classified doubtful. The remaining book value usually is classified substandard.
 - The entire book value of all defaulted municipal general obligation securities will be classified doubtful. Market depreciation on other defaulted bonds should

- be classified loss. The remaining book value usually is classified substandard.
- c. Market depreciation on nonexempt stock should be classified loss.
- d. Report comments should include:
 - Description of issue.
 - · How and when each issue was acquired.
 - · Default date.
 - Date interest paid to.
 - · Rating at time of acquisition.
 - Comments supporting the classification.
- 12. With regard to potential unsafe and unsound investment practices, review the list of securities purchased and/or sold since the prior examination and:
 - Determine if the branch engages one securities dealer or salesperson for virtually all transactions. If so:
 - Evaluate the reasonableness of the relationship on the basis of the dealer's location and reputation.
 - Compare purchase and sale prices to independently established market prices as of trade dates, if appropriate.
 - b. Determine if investment account securities have been purchased from the branch's own trading department. If so:
 - Independently establish the market price, as of trade date.
 - Review trading account purchase and sale confirmations and determine if the security was transferred to the investment portfolio at market price.
 - Review controls designed to prevent gains trading.

- Determine if the volume of trading activity in the investment portfolio seems unwarranted. If so:
 - Review investment account daily ledgers and transaction invoices to determine if sales were matched by a like amount of purchases.
 - Determine whether the branch is financing a dealer's inventory.
 - Compare purchase and sale prices with independently established market prices as of trade dates, if appropriate. The carrying value should be determined by the market value of the securities as of the trade date.
- 13. Discuss with appropriate officer(s) and prepare report comments on:
 - a. Defaulted issues.
 - b. Speculative issues.
 - c. Incomplete credit information.
 - d. Absence of necessary legal opinions.
 - e. Significant changes in maturity scheduling.
 - f. Shifts in the rated quality of holdings.
 - g Concentrations.
 - h. Unbalanced earnings and risk considerations.
 - i. Unsafe and unsound investment practices.
 - j. Apparent violations of laws, rulings, and regulations (including compliance with FAS 115).
 - k. Market value depreciation, if significant.
 - 1. Weaknesses in supervision.
 - m. Policy deficiencies.
- 14. Update workpapers with any information that will facilitate future examinations.

Securities Activities Internal Control Ouestionnaire

Effective date July 1997

Section 3130.4

Review the branch's internal controls, policies, practices, and procedures regarding purchases, sales, and servicing of the investment portfolio. The branch's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flow-charts, copies of forms used, and other pertinent information. For information on trading securities, refer to the *Trading Activities Manual*.

POLICIES

- Has local and head office management adopted written investment securities policies that outline:
 - a. Objectives?
 - b. Permissible types of investments?
 - c. Diversification guidelines to prevent undue concentration?
 - d. Maturity schedules?
 - e. Limitations on quality ratings?
 - f. Policies regarding exceptions to standard policy?
 - g. Valuation procedures and frequency?
- 2. Are investment policies reviewed at least annually by local and head office management to determine if they are compatible with changing market conditions?
- 3. Are securities designated at time of purchase as to whether they are held-to-maturity, available-for-sale, or trading? Who is responsible for the designation?
- 4. Have policies been established governing the transfer of securities between the held-to-maturity, available-for-sale, and trading accounts? Who is authorized to change a security's designation?
- 5. Do individual officers have set investment limits?
- 6. Do security transactions require dual authorization?
- 7. Are investment securities subject to credit reviews prior to purchase, and are annual reviews performed on nonrated issues and issues with significant deterioration?
- 8. Are securities purchases within prescribed approval limits?
- 9. Are below investment grade securities

- included on internal watch lists and subject to the same scrutiny as problem credits?
- 10. Are stress tests appropriately performed for high risk securities?

CUSTODY OF SECURITIES

- 11. Do procedures preclude the custodian of the branch securities from:
 - a. Having sole physical access to securities?
 - b. Preparing release documents without the approval of authorized persons?
 - c. Preparing release documents not subsequently examined or tested by a second custodian?
 - d. Performing more than one of the following transactions:
 - · execution of trades,
 - · receipt or delivery of securities,
 - receipt and disbursement of proceeds?
- 12. Are securities physically safeguarded to prevent loss or unauthorized removal or use?
- 13. Are securities, other than bearer securities, held only in the name or nominee of the branch?
- 14. Are bearer securities safeguarded appropriately?

RECORDS

- 15. Do subsidiary records of investment securities show all pertinent data describing the security; its location; pledged or unpledged status; premium amortization; discount accretion; and interest earned, collected, and accrued?
- 16. Is the preparation and posting of subsidiary records performed or reviewed by persons who do not also have sole custody of securities?
- 17. Are subsidiary records reconciled, at least monthly, to the appropriate general ledger accounts and are reconciling items investigated by persons who do not also have sole custody of securities?

PURCHASES, SALES AND REDEMPTIONS

- 18. Is the preparation and posting of purchase, sale, and redemption records performed or reviewed by persons who do not also have sole custody of securities or authorization to execute trades?
- 19. Are supporting documents, such as brokers' confirmations and account statements for recorded purchases and sales, checked or reviewed subsequently by persons who do not also have sole custody of securities or authorization to execute trades?
- 20. Are purchase confirmations compared to delivered securities or safekeeping receipts

to determine if the securities delivered are the securities purchased?

CONCLUSION

- 21. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Securities Activities Audit Guidelines

Effective date July 1997

Section 3130.5

- Verify the accuracy of the investment account trial balances.
- 2. Test the reconciliations of the trial balances to the general ledger.
- 3. If investments are held in safekeeping at locations outside the branch, request the safekeeping agent to provide lists of securities held including name, description, par value, interest rate, due date, pledge status, and payment date of next coupon.
- 4. Using appropriate sampling techniques, select certain investments and:
 - a. For investments held at the branch:
 - Examine and count the securities.
 - Compare details of certificates to trial balances.
 - If securities are pledged to secure the branch's liabilities, determine that they are properly segregated from other securities.
 - Determine if coupons are intact.
 - · Investigate any discrepancies.
 - b. For investments not held at the branch:
 - Compare trial balance details to safekeeping receipts and the safekeeping agent's confirmation list.
 - Determine that pledge status, if any, is properly noted on the safekeeping agent's confirmation list.
 - Investigate any discrepancies.
 - c. For investments purchased since the prior
 - Verify cost by examining invoices, broker's advices, or other independent sources.
 - Determine that the securities were properly recorded in the general ledger.
 - Determine that purchases were approved by local and head office management.
 - d. For investments purchased at a premium or discount, test book value by:
 - Determining the branch's method of calculating and recording amortization of premiums and accretion of discounts.
 - Determining the gross amount of premium or discount at purchase date.

- Determining the period to maturity or call date.
- Calculating the amount of premium remaining to be amortized or discount remaining to be accreted.
- Determining that book value is reflected properly in the general ledger.
- Investigating any discrepancies.
- Scanning previously tested amortization or accretion schedules for investments acquired before the prior audit and investigating any significant departure from these schedules.
- 5. Test gains and losses on disposal of investment securities since the prior audit by sampling investment sales records and:
 - a. Determining sales price by examining invoices or brokers' advices.
 - b. Checking computation of book value on settlement date.
 - Calculating gain or loss and tracing the amount to its proper recording in the general ledger.
 - d. Determining that the general ledger properly reflects the disposal of the investment and other related accounts.
 - Determining that sales were approved by local and head office management or a designated committee.
- 6. Test accrued interest by:
 - a. Determining the branch's method of calculating and recording interest accruals.
 - b. Determining that interest accruals are not being made on defaulted issues.
 - c. Randomly selecting certain transactions and:
 - Determining the interest rate and last interest payment date of coupons and money market instruments.
 - Calculating accrued interest and comparing it to the trial balance(s).
- If the branch is engaged in mortgage-backed or high risk securities, evaluate the interest risk exposure associated with the various instruments by performing independent stress tests.

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Funds management is an essential element of sound planning and financial management for any financial institution. A sound basis for evaluating funds management requires understanding the branch, its customer mix, the nature of its assets and liabilities, and its economic and competitive environment. No single theory can be applied universally to all branches. The purpose of funds management is to ensure adequate liquidity and effectively manage the spread between interest earned and interest paid. Therefore, funds management has two components: liquidity and interest rate risk management. This section primarily addresses liquidity. Interest rate risk management is addressed in Section 3210 of this manual, and should be read in conjunction with this section.

LIQUIDITY

Liquidity is defined as the ability to meet asset and liability obligations without delay, including the funding of loan commitments. In a sound liquidity management system, it is essential for a branch to provide for fluctuations in its balance sheet and meet immediate or day-to-day obligations as opposed to providing funds for long-term growth.

A branch generally has both internal and external sources of liquidity. Internal sources of liquidity include short-term, high-quality assets that are readily convertible to cash at a reasonable cost. External sources of liquidity include borrowings from related offices of the foreign banking organization (FBO), other financial institutions, and overnight or short-term depositors.

The price of liquidity is a function of general market conditions and the market's perception of the FBO. Generally, the higher the risk profile of the FBO, the higher the FBO's cost of funds and the greater its need to meet liquidity demands through the management of its liabilities. Generally, the market perception of the branch can be no better than the market perception of the FBO.

BRANCH/FBO RELATIONSHIP

Liquidity at a branch is closely integrated with

that of the FBO. While a branch, on a stand alone basis, may be able to obtain sufficient funding at a reasonable cost (by either increasing funding sources or converting assets to cash), from a market standpoint, there is no distinction between the branch and the FBO. Even if all of the branch's assets consisted of high-quality, liquid securities, liquidity would still be influenced by the market perception of the FBO as a whole.

In evaluating funds management and liquidity, the examiner should begin with an understanding of the FBO's current financial situation and be familiar with any potential liquidity concerns that could affect the branch.1 Generally, if the FBO is in sound financial condition and has satisfactory market ratings, the evaluation of liquidity at the branch will be a lesser concern. In such a case, the examiner should limit the analysis of liquidity to (1) reviewing information supporting the adequacy of liquidity at the FBO, (2) developing a thorough understanding of the branch's funds management and liquidity profile, and (3) reviewing how the branch's funding and liquidity are guided and monitored, either directly or indirectly, by the head office and/or a U.S. regional office.

In contrast, if the FBO's current financial condition or market perception raises concerns regarding funds management and liquidity, the examiner should conduct a more in-depth evaluation of branch liquidity. The evaluation should consider the branch's funds management profile with close attention to: (1) funding sources; (2) liquidity and funding gaps; (3) funds management policy guidance from the head office; (4) current economic and market conditions; and (5) the adequacy of the contingency funding plan. The examiner should be prepared to make recommendations to address any identified or potential concerns at the branch and, if appropriate, at other U.S. or U.S.-managed or controlled offshore operations.

FBOs with multiple U.S. operations may centralize funds management and liquidity at a regional U.S. office. The examination of such a regional U.S. office, therefore, should include an evaluation of funds management and liquidity

^{1.} This information is available to examiners as a part of the FBO's annual strength of support assessment. Examiners should review this assessment as a part of the pre-examination planning process, and be prepared to consider this information in evaluating the branch's funds management and liquidity.

for the branch's entire area of responsibility, including any U.S.-managed or controlled off-shore operations.

FUNDS MANAGEMENT AND LIQUIDITY PROFILE

The examiner should understand and evaluate the branch's funding and liquidity profile. Regardless of the condition of the FBO, the branch's funding profile, or whether the branch manages its own funding needs, this review should begin with an understanding of the FBO's funds management guidelines and practices for the branch. Head office should provide branch management with funds management and liquidity guidelines and some method of daily monitoring compliance with these guidelines. Generally, the greater the complexity of the branch or its responsibilities in funds management and liquidity, the more comprehensive the guidelines and monitoring practices.

A major point to consider in evaluating branch liquidity is whether the FBO views the branch as a net user or provider of funds. The examiner should determine if the FBO has been a consistent supplier of funds, or whether the branch acts as a dollar funding vehicle for the FBO. This determination, which is particularly important if the FBO raises liquidity concerns, will be evident from the trend in the net "Due From" position with related parties. The examiner should review a period of branch quarterly Reports of Assets and Liabilities (FFIEC 002) to determine the direction, volume, and frequency of the flow of funds between the branch and its head office or other related parties, including U.S.-managed or controlled offshore operations. The examiner should take into consideration that an analysis of quarter-end reports may not provide a true picture of ongoing activities due to certain types of balance sheet window dressing activities employed by the branch. Average statements of condition should be obtained in order to get a true picture of branch liquidity over time. From a supervisory viewpoint, a net due to position is regarded more favorably than a net due from position because it provides a cushion for nonrelated depositors and creditors. However, any recommendations related to the branch's funding role should be considered in relation to the FBO's overall financial condition and other factors discussed in this section. For

additional information on funding transactions with related parties, refer to Section 3240, Due From/Due To Related Parties.

The evaluation of funds management and liquidity should also consider the branch's cost and distribution of funds; economic and market trends; levels of liquid assets; future earnings capacity; asset quality; concentrations; customer mix; the nature and mix of its assets and liabilities, including maturity, currency and repricing mismatches; and its anticipated funding needs. Generally, these considerations are more significant if the branch manages its own funding and liquidity needs.

The remaining discussion is applicable to branches that are not simply net users of funds and have some degree of control over their funds management.

POLICY GUIDANCE

Branch management is expected to maintain policies and procedures approved by head office that facilitate the development of funding and liquidity strategies. Policies and procedures should provide an outline of goals regarding the FBO's asset and liability management, liquidity, off-balance-sheet exposure, degree of risk tolerance, and other relevant factors. The individual or committee responsible for funds management decisions, including monitoring anticipated funding needs, funding strategies, guidelines and limitations, should be specified in the policies and procedures. The depth of these policies and procedures will depend upon the degree to which branch management is responsible for funds management. In some cases, the head office or U.S. regional management is largely responsible for funds management at the branch. In other cases, responsibility rests with local branch management.

Policy statements should address limitations on funding sources to avoid a concentration to any one source or grouping. They also should identify alternative funding sources, the degree of support dictated by the FBO, and the nature of that support. Interest rate sensitivity matching, maturity matching, and the use of financial derivatives may be addressed under these policies or in a separate interest rate risk policy. Written procedures should provide staff with a reference document on the day-to-day proce-

dures in funding and provide for a system of internal control in critical areas, such as separation of duties, proper completion of reports, and monitoring of limits. Refer to Interest Rate Risk Management, Section 3210 for additional information on policies and procedures.

MANAGEMENT INFORMATION SYSTEMS

An effective Management Information System (MIS) is integral to making sound funds management and liquidity decisions and is a factor in evaluating the branch's financial controls. Reports containing certain basic information should be prepared and reviewed regularly by management. Report content and format will vary among branches; however, an effective MIS will contain reports detailing liquidity needs and the sources of funds available to meet those needs. Typically MIS may include the following: the maturity distribution of assets and liabilities, and the related gaps, including maximum and minimum liquidity needs; expected funding of commitments; asset yields; liability costs; net interest margins and variances (both from prior months and budget); funding volumes by liability, customer, market, and overnight/short-term funds; and exceptions to policy guidelines and limits. Refer to Section 3410, Management Information Systems, for additional information.

FUNDING AND LIQUIDITY PRACTICES

A branch responsible for its own funding and liquidity needs may meet those needs by manipulating its asset structure through the sale or planned runoff of short-term or readily marketable assets. As an alternative, the branch could transfer to the head office or other related offices, a block of assets that would serve to reduce its asset base and increase liquidity. As a matter of general practice, however, a branch can meet its liquidity needs by manipulating its liability structure to access discretionary funding sources or derive funds from its intercompany funding base. The ability of a branch to access discretionary funding sources is ultimately a function of the position and reputation of the FBO in the money markets. An FBO with a good reputation affords its branches easier access to funds at market rates.

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

Frequently, the base rate for funding costs on money market transactions is available only to the largest and most financially sound institutions. Some branches may pay in excess of the base rate for money market funds, with the differential denoting the market's perception of the FBO and home country conditions. The size of the premium compared to other FBOs can be a rough indication of the stability of funding sources in this market. As indicated earlier, if the FBO carries a rating of AAA or AA by an independent rating agency, it is unlikely that funding and liquidity will be an examination issue. If the FBO carries a lower rating or has no market presence, the probability that there may be funding and liquidity concerns grows proportionately and funds management and liquidity are more critical.

FUNDING AVAILABILITY

Management at the branch and head office must be constantly aware of the composition, characteristics, and diversification of its funding sources. If possible, the branch should secure funding lines from multiple sources. In certain instances, the branch may be using suballocated lines from its head office. With multiple source advised discretionary lines of credit, the branch is much better positioned to manage usage and rotation in order to ensure availability of funds at competitive pricing. The role of the FBO in this circumstance would be to provide backup resources and to be the ultimate lender for contingency purposes.

Nevertheless, many interbank credit agreements contain escape provisions, known as material adverse change clauses, that enable the lending bank to refuse to allow the borrowing bank to draw on advised credit lines. Banking organizations experiencing considerable problems, particularly those relating to asset quality and/or liquidity, have found that these facilities are no longer available. Such escape provisions should be considered in the assessment of funds management and liquidity.

CONTINGENCY FUNDING

Examiners should determine if management at the branch has an effective contingency plan that identifies minimum and maximum liquidity needs both in normal and adverse market conditions, and weighs alternative courses of action to meet these needs. The branch may rely on back-up funding lines or support from the head office or other related offices to meet unforeseen liquidity demands. In this case, examiners should comment on the FBO's ability to meet these needs.

HOME COUNTRY FUNDING RESTRICTIONS

An FBO's home country may impose restrictions on capital outflows. Such impediments could defeat the attempts of the FBO to aid the branch in the event of a liquidity crisis. For this reason, the examiner should investigate home country funding restrictions.

TRANSFER RISK CONSIDERATIONS

The stability and availability of funding should be related to the distribution of assets, taking into consideration certain assets subject to transfer risk. Potential liquidity problems may exist when a branch relies heavily on the U.S. money market for funding, while its assets are concentrated in a country with serious economic problems. In such a case, the branch is typically in a net due from position with the FBO and problems may arise if the FBO or borrowers do not have ready access to U.S. dollars to meet their obligations. Refer to Section 6020, Transfer Risk, for additional information.

OFF-BALANCE-SHEET CONSIDERATIONS

The nature, volume and anticipated usage of off-balance- sheet activity must be factored into the assessment of funds management and liquidity. The potential for funding contingent liabilities varies widely, but the most likely to require funding are loan commitments. Economic conditions and the business cycle may also influence anticipated usage. The branch should have sufficient existing funding sources to provide for anticipated usage, in view of the nature and volume of its contingent liabilities.

Funds Management and Liquidity Examination Objectives

Effective date July 1997

Section 3200.2

- To assess the branch's ability to obtain stable funding sources from related and unrelated parties.
- To determine if reasonable local policies, procedures, and parameters have been established and approved by the head office for the branch's liquidity position and if the branch is operating within those established guidelines.
- 3. To evaluate the management of assets, liabilities, and off-balance-sheet positions to determine if management is planning adequately

- for liquidity and if the branch can effectively meet anticipated and potential liquidity needs.
- 4. To determine if internal management reports provide the necessary information for informed liquidity decisions and monitoring their results, and that reports are regularly provided and reviewed by head office.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Funds Management and Liquidity Examination Procedures

Effective date July 1997

Section 3200.3

- Evaluate the funding relationship between the branch and the FBO. Consider the reasons why the branch is in a net due from or due to position with related offices and affiliates of the FBO.
- 2. Review the Funds Management and Liquidity policies, practices, and procedures and test for compliance. Ensure that there are:
 - a. Lines of authority and responsibility for liquidity management decisions.
 - Formal mechanisms to coordinate funds management and liability decisions.
 - c. Methods to identify liquidity needs and the means to meet those needs.
 - d. Guidelines for the level of liquid assets and funding sources in relation to anticipated and potential needs.
 - Appropriate controls and supervision of the volume of loan commitments and other off-balance sheet exposure that may impact funding and liquidity.
- Determine if management has planned properly for liquidity and if the branch has adequate sources of funds to meet anticipated or potential needs by:
 - Reviewing the internal management reports detailing liquidity requirements and sources of liquidity.

- Evaluating primary and secondary sources of funds.
- c. Determining whether funding and liquidity requirements are factored into the budgeting process and are based on growth projections, changes in the branch's asset and liability mix, and other anticipated changes.
- Evaluate the effectiveness of the internal management reporting system in providing for adequate liquidity management.
- 5. Discuss the following issues with management and summarize findings in the workpapers and, to the degree necessary, for the examination report:
 - a. The quality of the branch's planning and the current ability of the branch to meet anticipated and potential liquidity needs.
 - b. The quality of administrative control and internal management reporting systems.
- 6. Update the workpapers with any information that will facilitate future examinations. Discuss with senior branch management the findings of the examination regarding the branch's funding and liquidity policies and practices, and document the discussion in the workpapers.

Funds Management and Liquidity Internal Control Questionnaire

Effective date July 1997

Section 3200.4

- 1. Is the FBO in less than satisfactory condition and subject to liquidity concerns?
- 2. Is the FBO subject to market disciplinary pricing?
- 3. Does the FBO's home country impose restrictions on capital outflows?
- Has the branch and head office management, consistent with its duties and responsibilities, adopted funds management policies, practices and procedures which include:
 - a. Lines of authority, and responsibility for funds management and liquidity decisions?
 - b. A formal mechanism to coordinate funds management and liquidity decisions?
 - c. A method to identify funding and liquidity needs and the means to meet those needs?
 - d. A contingency funding plan that provides guidelines for the level of liquid assets and other sources of funds in relationship to anticipated and potential needs?
 - e. An adequate system of internal controls in critical areas, such as separation of duties, proper MIS reporting and monitoring of limits?
 - f. Transfer risk considerations?
- 5. Does the FBO view the branch as net user or provider of funds?
 - If the branch is a net user of funds:
 - a. Does the branch have a funding and liquidity profile that identifies the branch as a non-risk taker?
 - b. Are funds management and liquidity decisions centralized at an FBO location within the U.S. that is subject to regulatory supervision?
 - If the branch is a net provider of funds, answer the following questions; otherwise proceed to question 12.
- 6. Have internal management reports been prepared that provide an adequate basis for

- making ongoing liquidity management decisions and for monitoring the results of those decisions?
- Do management reports include the following:
 - a. Maturity distribution of assets and liabilities?
 - b. Expected funding commitments?
 - c. Asset yields and liability costs?
 - d. Net interest margin and variance analysis (e.g., previous month, quarter, year-todate and budget reporting)?
 - e. Funding volumes by type of liability (e.g., overnight/short-term funds), customer and market?
 - f. Exceptions to policy guidelines and limits?
- 8. Does the planning and budgeting function consider funding and liquidity requirements?
- 9. Does the branch's contingency funding plan address:
 - a. Minimum and maximum liquidity needs and alternative courses of action to meet those needs?
 - b. Alternative sources of funding?
 - c. Orderly asset liquidation?
- 10. Have adequate discretionary (back-up) lines of credit been established?
- 11. Are advised discretionary lines of credit containing adverse change clauses considered by branch management in its contingency funding plan?
- 12. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e., strong, satisfactory, fair, marginal, unsatisfactory).

Effective date July 1997

Interest rate risk (IRR) is an aspect of normal banking operations that became increasingly important in the United States with the deregulation of interest rates in the early 1980s. The phaseout of interest rate controls and increased competitiveness, the latter of which was partly due to the growing presence of foreign banks in U.S. markets, significantly increased the flexibility of banks in adjusting their IRR profiles. This flexibility has been further enhanced by the development of new financial instruments used to hedge against or profit from interest rate changes.

In order to maintain profitability, safety, and soundness, institutions should fully comprehend the risks associated with changes in interest rates and should have adequate policies and systems in place for controlling these risks. In this regard, the branch and its head office management both have important responsibilities.

The head office is responsible for providing clear policy guidance to branch management on controlling and monitoring IRR. The policies provided to branch management by the head office should indicate acceptable levels of risk-taking, given the branch's role in the foreign banking organization (FBO), and establish procedures and controls to ensure that there is an adequate system for measuring IRR and monitoring compliance with established limits. In this regard, there should also be a reporting process that demonstrates adherence with established limits and an adequate system of internal controls.

It is recognized that, as part of a larger entity, IRR management for certain branches may be centralized within the FBO. Whether or not the branch is responsible for managing its IRR, there should be evidence at the branch, in the form of IRR policy guidelines, management reports, etc., showing how this risk is being effectively identified, measured, and controlled for the branch. The following discussion provides an overview of IRR considerations, which the examiner should use in reviewing, to the extent applicable, this area of risk within the branch.

INTEREST RATE RISK

IRR is defined as a branch's vulnerability to changes in interest rates. IRR arises from differ-

ences in the maturities or repricing dates of asset and liability positions, and cash flows. However, risk may remain in a given branch's portfolio in which long and short positions of different maturities are well hedged against a uniform change in all interest rates, but not against a change in the shape of the yield curve where interest rates of different maturities change by varying amounts. This type of risk is called "yield-curve risk." Similarly, a branch may be well hedged against yield curve risk but exposed to "basis risk," in which the prices of particular assets and liabilities, as well as hedging instruments, are not perfectly correlated. For example, three-month interbank deposits priced at LIBOR, three-month Eurodollars and three-month Treasury bills all pay three-month interest rates. However, these three-month rates are not perfectly correlated with each other and spreads between their yields may vary over time. As a result, three-month Treasury bills, for example, funded by three-month interbank deposits are not a perfectly hedged position. Given a rise or decline in interest rates, a branch's interest rate exposure can be viewed as the potential for change in its reported earnings.

Focusing on the sensitivity of a branch's reported earnings to changes in interest rates represents an accounting perspective of IRR assessment. In general, this approach involves assessing the effect that changing rates might have on the revenues produced by interest-earning assets, the expense of interest-bearing liabilities, and the resulting net interest income of the branch. Risk to current earnings measures the timing of income effects, which can help risk managers determine what action to take regarding exposure.

RISK MEASUREMENT TECHNIQUES

Branches can use a variety of methods to measure their IRR exposure. The three most common generic methods are maturity gap analysis (used to measure the interest rate sensitivity of earnings), duration analysis, and simulation modeling. While these methods highlight different facets of IRR, many branches use them incombination or use hybrid methods that combine features of each.

Maturity Gap Analysis

Maturity gap analysis begins with constructing a maturity gap report. This report categorizes asset and liability accounts, including offbalance-sheet items, according to the time remaining to their maturities in specific time periods, known as repricing buckets. These buckets vary from branch to branch, but most branches include time bands of overnight, overnight to one month, one month to three months, three months to six months, six months to one year, and beyond one year. Categorizing assets and liabilities lacking definitive repricing time frames into specific time periods (or buckets) varies by institution. As a result, the assumptions used by each institution should be reviewed by the examiner to ensure that they are reasonable. This approach reflects the accounting or current earnings orientation of gap reports.

For each time period or bucket, rate-sensitive liabilities (RSL) are subtracted from rate-sensitive assets (RSA) to yield the dollar maturity mismatch or gap . The gap measure is either a positive or negative dollar amount and is the primary tool used to assess the impact of changes in interest rates on the institution's net interest income.

A negative gap (liability sensitive) indicates that more liabilities than assets will reprice in a given time period. During periods of rising interest rates, net interest income would be adversely affected because the interest expense on liabilities during that period would show a greater increase relative to the increase in interest earnings on assets. If rates decline, a bank with a negative gap would expect its earnings to be enhanced because more liabilities than assets would reprice at lower rates.

Conversely, a positive gap (asset sensitive) indicates that more assets than liabilities will reprice in a given time period. In this case, earnings tend to increase as interest rates increase because more assets than liabilities reprice at higher rates.

The maturity gap of an institution is the most basic measure of IRR. It is a static measure that assumes the current balance sheet remains constant through time and a given change in interest rates is not reversed over time. For this reason, it may not accurately reflect a branch's true risk exposure. In addition, its emphasis on the risk to short-term earnings inadequately addresses the rate sensitivity of longer-term fixed rate instru-

ments, the value of which can change dramatically without affecting short-term interest income.

Some simple forms of maturity gap analysis identify only the amount of assets and liabilities at risk and ignore basis risk. Basis risk refers to the likelihood that changes in interest rates a branch pays on liabilities and earns on its assets are not perfectly correlated. That risk is present, even when the assets and liabilities are matched in terms of their maturity or repricing periods. Despite these shortcomings, most branches use maturity gap analysis or some variant, as one component of IRR measurement. Many branches elaborate on the simple gap framework in order to gain insight into the more complex aspects of IRR

While the maturity gap of an institution is a widely used indicator of IRR, it is not a sufficient measure for gauging overall exposure when taken alone. A branch's condition and size, complexity of the balance-sheet and off-balance-sheet activities (if any), degree of competition, and sophistication of the markets being served also must be considered. For example, a small, retail-oriented branch may have moderately large negative gap positions but may not be exposed to major risks. Factors that may minimize such risks are the branch's strong core deposit base within its target market.

Duration Analysis

Duration analysis is used to calculate the weighted average maturity of the cash flows emanating from financial instruments. In contrast to the simple average nominal cash flows, duration provides more meaningful, analytical measures of a stream of cash flows. The duration measure can be used to calculate the percentage change in the present value of a stream of cash flows that is generated by a one percentage point change in interest rates. Duration analysis can measure the exposure of a branch's current income to changes in interest rates.

Duration analysis can complement gap analysis. Using gap repricing data and selected rate data, duration provides a more accurate measure of IRR. Duration analysis, unlike gap analysis, accounts for the time value of money by calculating the present value of future cash flows. In so doing, it properly aggregates the branch's repricing mismatches or gaps. Thus, duration can be used to analyze the risk standing of a

branch with a complicated series of repricing mismatches. Like gap analysis, duration analysis generally assumes that the repricing structure of a branch's assets and liabilities remains constant. In addition, duration analysis requires information on cash flows that may not always be available.

Used in conjunction with maturity gap analysis, duration analysis can add significant insights into the IRR exposure of an institution. However, duration also has some limitations, in particular:

- The duration measure becomes less accurate as the amount of the interest rate change increases;
- The duration of different instruments will change at different rates as time passes, resulting in a hedged position becoming unhedged over time; and,
- Duration alone does not address the dispersion of cash flows in a branch's portfolio.

Simulation Modeling

Simulation techniques attempt to overcome the limitations of both the static gap and duration measures by computer-modeling the branch's interest rate sensitivity. Such modeling involves making assumptions about the future course of interest rates and changes in a branch's business activity and estimating their effect on the branch's net interest income. Branches can develop their own simulation packages or choose from a variety of commercially available packages.

A simulation model can provide branch management with an important tool for understanding the measurement of, and assisting in the management of, IRR, and for evaluating the branch's exposure under a variety of interest rate scenarios. Simulation techniques can also play an integral planning role in evaluating the effect of alternative business strategies on risk exposure. Unlike other methods, simulation can anticipate the effect of changes in customer behavior induced by interest rate changes (such as time deposit rollovers, in retail branches).

The usefulness of simulation techniques depends on the validity of the underlying assumptions and the accuracy of the basic structure upon which the model is run. If these assumptions do not fairly reflect the branch's

internal and external environment, the results obtained will not be meaningful.

ASSESSMENT OF IRR MANAGEMENT

Examiners should focus on the presence of clear and comprehensive policies with corresponding appropriate internal controls when assessing the management of IRR. The policies should outline the following: the objectives of risk management, clear lines of authority and communication, and limits on the vulnerability of net interest income to changes in interest rates. Risk management systems and procedures should be adequate and consistent with the stated policies of risk management.

Strong internal management controls need to be maintained given the potential impact of interest rate exposure on a branch's earnings. These controls include policies, risk measurement systems, and reporting mechanisms. Each of these should be reviewed from two perspectives:

- Does management understand and effectively administer IRR controls?
- Do these controls establish reasonable parameters considering the specific IRR profile of the branch?

In larger branches, IRR may be managed by an Asset/Liability Management Committee (ALCO), which is composed of senior branch managers who represent units that undertake IRR. ALCO is responsible for formulating and administering branch strategy with regard to IRR, which is based on management's view of the future interest rate environment, the branch's relative ability to adjust to changing market conditions, and the head office's risk-acceptance level. The activities of ALCO, including the implementation of IRR policies, should be reviewed for approval by the head office.

Additionally, in the cases where IRR management is centralized at a particular branch of the FBO, the following question must be considered: Is the process of transferring a given branch's IRR to the portfolio of the branch housing the centralized IRR management function adequately governed by appropriate policies and accurate reporting mechanisms?

POLICIES

The need for established and properly supervised IRR policies has increased greatly in recent years. An adequate policy facilitates the development of a prospective plan that considers the branch's goals regarding its asset and liability mix, off-balance-sheet activities, liquidity, risk tolerance, and other relevant factors. The policy should establish responsibility for IRR management decisions and provide a mechanism for the necessary coordination among different departments of the branch, or between different branches of the FBO, as appropriate.

In addition to establishing responsibility for planning and day-to-day IRR decisions, the policy should set forth certain guidelines:

- Interest rate exposure limits should be established relative to reasonable forecasts and assumptions;
- Limits should be based on the potential impact of interest rate changes on the branch's net interest income:
- Individual limits should be set for units that incur IRR;
- Clear lines of authority and communication should be established for the implementation and execution of strategies; and,
- For those branches that are not authorized to incur or manage IRR, the policy should clearly outline procedures for accurately and effectively transferring the IRR incurred by its normal business activities to a designated branch or other office of the FBO responsible for the centralized management of IRR.

In most cases branches accomplish the transfer of IRR incurred by a given transaction by entering into an offsetting, "mirror" transaction with the office responsible for managing the branch's IRR. As an example, if a branch entered into a five-year, fixed- rate loan, it could book a five-year, fixed-rate liability to the related office to fund the loan; the maturity and principal amount should be matched.

RISK MANAGEMENT SYSTEMS

The effectiveness of assessing IRR through the use of a risk management system depends to a large degree on the branch's ability to measure its exposure. Risk management systems are based on a quantitative assessment of exposure

(as previously discussed) and management's adaptation and analysis of that assessment. These systems should be:

- · Consistent with established limits;
- Comprehensive, covering the rate risk associated with all asset, liability, and off-balance sheet accounts:
- · Capable of identifying excessive exposure;
- Capable of measuring the impact of rate changes on the branch's chosen target account(s):
- Flexible, so that the introduction of new instruments and changes in strategy can be absorbed and accounted for; and,
- Able to suggest strategies for corrective action.

REPORTING MECHANISMS

Strong lines of communication and authority are essential to the timely execution and adjustment of a branch's IRR strategy because earnings can be rapidly eroded by unexpected rate changes. In particular, when risk management responsibilities are delegated to those most familiar with particular products or markets, the need for communication becomes stronger, so that positions in one market are not excessively magnified by positions elsewhere.

Coordination between the branch and head office management and business units that incur IRR is essential to the successful control of IRR. This is especially important when the business unit incurring IRR is another branch of the FBO. Controls should focus on the following:

- Branch and head office management should be regularly apprised of the nature and results of risk management decisions undertaken by the branch:
- Branch and head office management should be provided with periodic status reports detailing risk exposure;
- Treasury management should have periodic contact with branch line managers responsible for undertaking risk;
- Risk-taking units should be aware of limits established by head office and/or branch management, with limit exceptions regularly monitored and communicated to senior management; and.
- Units not allocated risk limits should provide the branch responsible for its IRR manage-

ment with reports detailing not only the unit's current positions, but potential or planned transactions, as well.

PRICING

Conclusions drawn from the analysis of the branch's interest rate sensitivity position rest upon the assumption that the branch has an adequate asset-pricing mechanism. A pricing mechanism that is not attuned to the branch's cost of funds, overhead costs, and credit risk will not allow the branch to maintain an adequate net interest margin on an ongoing basis. Thus, the examiner should bear in mind the interdependence of pricing methods and interest rate sensitivity when assessing the branch's ability to maximize and maintain the spread between interest earned and interest paid.

An important component of pricing is the cost of funds. Bankers generally price from either the average cost of funds or the marginal cost of funds. The average cost of funds is a weighted average of all of the rates paid on interest-bearing liabilities. The marginal cost of funds is defined as the cost of the additional funds needed to support asset growth and is considered by many bankers to be the more economically appropriate method. This view is taken because funds on the balance sheet already support assets held and the cost of those funds should not enter into the pricing decision for new assets.

The marginal cost of funds is not, however, always the best method of pricing because the branch may be replacing assets, instead of growing. If the branch is only changing its asset mix to compensate the organization for its credit risk, its average cost of funds, plus overhead and repricing considerations, represent a more appropriate pricing measure. Additionally, market forces, which include the demand for and availability of funds, should be considered as complements to cost factors when making pricing decisions. The market in which the branch operates often dictates the pricing mechanism used.

Branches most often obtain funds from the domestic interbank money market; however, offshore sources, including related branches and the head office, are frequently used. In many cases, a FBO may have to pay an additional spread over interbank rates for perceived country risk, liquidity risk, or credit risk. For branches required to pay such additional spreads, the size and volatility of these premiums should be considered in the institution's pricing mechanism.

HEDGING

The examiner should keep in mind that risk may be reduced by hedging activities when determining the extent of IRR exposure at the branch. These activities may be explicit and easily quantifiable or they may be implicit and difficult to measure from the branch's management information system.

Types of explicit hedging activities include instruments such as futures, interest rate swaps, forwards, options, and various hybrid products. Types of implicit hedging might include interest rate caps and floors on commercial loans; limits on the amount of rate adjustment allowed for products, such as adjustable rate mortgages; or even investment policies that might set internal stop loss limits on various longer-term portfolio positions. Explicit hedging strategies can either be matched to a specific asset or liability ("micro" hedges) or be designed to reduce the overall level of risk in a position ("macro" or "portfolio" hedging).

Institutions engaged in hedging activities should have clearly defined policies that outline specific hedge strategies and explain how those strategies reduce risk. Individuals responsible for hedging activity should be designated and overall position limits should be established. Internal controls should be established to include a system that measures the degree to which a hedge is meeting its stated objective of reducing risk (hedge effectiveness). Finally, branch management should regularly provide reports to the head office that, at a minimum, show gains or losses on hedge instruments and estimates of hedge effectiveness.

Finally, some entities now use derivative instruments in managing IRR. The individual regulatory agencies have issued policy statements regarding derivative instruments. The examiner should consult with his/her respective agency for guidance.

Interest Rate Risk Management Examination Objectives

Effective date July 1997

Section 3210.2

- 1. To evaluate the policies regarding interest rate risk (IRR) formulated by branch and head office management, including the limits established for the branch's IRR profile.
- 2. To determine if the branch's IRR profile is within those limits.
- 3. To evaluate the management of the branch's IRR, including the adequacy of the methods and assumptions used to measure IRR.
- To determine if internal management reporting systems provide the information necessary for informed interest rate management decisions.
- To recommend corrective action when interest rate management policies, practices, procedures, or internal controls are deficient in controlling and monitoring IRR.

Interest Rate Risk Management Examination Procedures

Effective date July 1997

Section 3210.3

- Determine if there were concerns in the previous examination report regarding IRR, and if corrective action was required.
- 2. Determine if IRR is managed at the branch level or at another level within the FBO.
 - a. If IRR is managed at the branch level, proceed to procedure #3.
 - b. If IRR is managed at a higher level within the FBO:
 - Determine if adequate procedures are in place for any activities at the branch which are required by the managing level within the FBO (i.e. personnel authorized and steps necessary for calling in funding requirements).
 - Provide a description of the activities conducted by the managing level within the FBO.
 - Proceed to procedure #10.
- Review the branch's written policies and procedures for reasonableness. At a minimum, policies should cover:
 - Definition and measurement of acceptable risks, including acceptable levels of interest rate exposure.
 - b. Net interest margin goals.
 - c. Sources and uses of funds.
 - d. Off-balance-sheet activities that affect interest rate exposure.
 - e. Responsibilities within the branch for IRR management activities.
 - f. Reporting mechanisms.
- 4. Evaluate the internal controls and/or the internal audit function. Determine whether internal mechanisms are adequate to ensure compliance with established limits on IRR. Prepare a brief description of the branch's internal controls/audit for IRR management and identify areas in need of improvement.
- 5. Evaluate management practices. The evaluation should include, but not be limited to, the following:
 - a. Determine who is responsible for making IRR management decisions (individual, committee or other), and whether this is appropriate, given the level of experience and sophistication of the individuals and the nature of the branch's activities.
 - b. Determine who is responsible for making principal assumptions and param-

- eters used in the measurement system(s), and whether this individual or committee reviews the principal assumptions and parameters on a regular basis and updates them as needed.
- c. Determine who is responsible for implementing strategic decisions. Ensure that the scope of that individual's authority is reasonable. Determine if any one individual exerts undue influence over the economic forecasts and management decisions.
- d. Assess branch management's knowledge of IRR in relation to the size and complexity of the branch. In particular, assess management's understanding of the methods used by the branch to measure the risk
- Determine if new products or hedging instruments are adequately analyzed before purchase.
- Assess senior management (i.e. lead U.S. office for FBO or head office) oversight of IRR management. The assessment should include the following:
 - Determine how frequently the policy is reviewed and approved by senior management (at least annually).
 - b. Determine whether the results of the measurement system provide clear and reliable information and whether the results are communicated to senior management at least quarterly. Reports to senior management should identify the branch's current position and relationship to policy limits.
 - c. Determine the extent to which exceptions to policies and resulting corrective measures are reported to senior management, including the promptness of such reporting.
- 7. Evaluate the risk measurement system(s) used by the branch, which should be consistent with the size and complexity of its on- and off-balance-sheet activities. The evaluation should include the following:
 - Evaluate whether the risk measurement system's structure and capabilities are adequate to accurately assess the risk exposure of the branch, support the institution's risk management process,

- and serve as a basis for internal limits and authorizations.
- b. Evaluate whether the risk measurement system is operated with sufficient discipline to accurately assess the risk exposure of the branch, support the institution's risk management process, and serve as a basis for internal limits and authorizations.
- c. Determine whether the assumptions are reasonable given current business conditions and the institution's strategic plan, and whether assumptions about future business are sensitive to changes in interest rates.
- 8. Evaluate the branch's exposure to IRR by:
 - Reviewing reports regularly prepared by management for controlling and monitoring IRR.
 - Reviewing "variance reports," i.e., reports that compare predicted and actual results.
 Comment on whether the risk measurement system has made reasonably accurate predictions in earlier periods.
 - c. Determining whether the level of risk is within the limits management has set.
 - d. Determining the stability of interest margins under varying economic conditions or simulations (causes of significant fluctuations should be identified).
 - e. Determining the branch's ability to adjust its interest rate exposure, or its ability to effectively transfer its interest rate exposure to the designated unit of the FBO for IRR management.
- 9. Contact the examiner responsible for analyzing income and expense to determine the

- adequacy of the net interest margin, based on an analysis of the components of the margin (i.e., interest expense and interest income). If the margin or any component is unusually high or low, determine:
- a. If goals have been established for net interest earnings.
- b. Management's success in meeting established goals.
- c. The effect of the branch's IRR position on meeting established goals.
- d. The effect of the branch's pricing policies on meeting established goals.
- e. The effect of any premium charged the branch on borrowed funds resulting from any perceived liquidity risk, country risk, or credit risk on meeting established goals.
- f. The effect of the branch's credit risk appetite on the margin.
- g. The effect of interoffice pricing policies for borrowed funds from related offices, and the reliance on these funds, on the margin.
- 10. Write in appropriate report format and discuss with management:
 - a. The quality of management's ability to control and monitor IRR.
 - b. The level of the branch's IRR exposure and an assessment of the associated degree of risk.
 - The quality of the related administrative controls and internal management reporting systems.
 - d. The effect of IRR management decisions on earnings.
- Update the workpapers with any information that will facilitate future examinations.

Interest Rate Risk Management Internal Control Questionnaire

Effective date July 1997

Section 3210.4

Complete the following questions only if IRR is managed at the local level. If IRR is managed at another level within the FBO, determine that adequate procedures are in place for any activity required of the branch by the managing office.

- Has branch and head office management adopted an IRR management policy that includes:
 - a. Risk management philosophy and objectives regarding IRR?
 - b. Clear lines of responsibility to either manage IRR or transfer the branch's IRR positions to the appropriate unit of the FBO assigned the IRR management function?
 - c. Defining and setting of limits on IRR exposure?
 - d. Specific procedures for reporting and approvals necessary for exceptions to policies and limits?
 - e. Plans or procedures management will implement if IRR falls outside established limits?
 - f. Specific IRR measurement system(s)?
 - g. Acceptable activities used to manage or adjust the institution's IRR exposure, including, when applicable, procedures for the transfer of IRR to the unit assigned the IRR management function?
 - h. The individuals or committees who are responsible for IRR management decisions?
 - i. A process for evaluating major new products and their IRR characteristics?
- 2. Have internal management reports been prepared that provide an adequate basis for making interest rate management decisions and for monitoring the results of those decisions? Specifically:
 - a. Are reports prepared on the branch's IRR exposure, using an appropriate measurement method?
 - b. Is historical information on asset yields, cost of funds, and net interest margins readily available?
 - c. Are interest margin variations, both from the prior reporting period and from the budget, regularly monitored?
 - d. Is sufficient information available to permit an analysis of the cause of interest margin variations?

- 3. Is the bank in compliance with its policies, and is it adhering to its written procedures? If not, are exceptions and deviations:
 - a. Approved by appropriate authorities?
 - b. Made infrequently?
 - c. Nonetheless consistent with safe and sound banking practices?
- 4. Does senior management review and approve the policy at least annually?
- 5. Did senior management review positions, and the relationship of these positions to established limits, at least quarterly?
- 6. Were exceptions to policies promptly reported to the senior management?
- 7. Does one individual exert undue influence over interest risk management activities?
- 8. Discuss with senior management the branch's internal risk measurement model(s) regard to the following:
 - a. Has (Have) internal model(s) been audited (by internal or external auditors)?
 - b. Does one individual control the modeling process, or otherwise exert undue influence over the risk measurement process?
 - c. Is the model reconciled to source data to assure data integrity?
 - d. Are principal assumptions and parameters used in the model reviewed periodically by senior management?
 - e. Are the workings of, and the assumptions used in, the internal model adequately documented and available for examiner review?
 - f. Is the model run on the same scenario(s) for which the institution's limits are established?
 - g. Does management compare the historical results of the model to actual results?

CONCLUSION

- Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Effective date July 1997

Borrowed funds include all nondeposit liabilities, exclusive of long-term subordinated debt, such as capital notes and debentures. Common forms of direct borrowing include Federal funds purchased (overnight and term), bills payable to the Federal Reserve, interbank deposits (domestic or foreign), due bills, short sales from trading securities, and overdrafts on deposit accounts due from other depository institutions. Indirect forms of borrowing include rediscounted customer paper, trade bills and bankers acceptances, securities borrowed, and assets sold with the endorsement or guarantee of the FBO or subject to a repurchase agreement. If an FBO issues commercial paper in the U.S., the issuance is generally through a U.S. subsidiary and reflected on the books of the branch as a balance due to related institutions.

When a branch manages its borrowed funds position independently from other FBO offices, a complete analysis of its borrowing activities since the previous examination should be done. The principal sources of borrowings, the range of amounts, frequency, length of time indebted, concentration of borrowings, and reasons advanced by management for such borrowings should be explored. Some of the more frequently used sources and instruments that provide short-term, nondeposit funds are discussed below.

INTRACOMPANY/INTERCOMPANY BORROWING

A principal borrowing relationship frequently exists between a branch and its head office. The branch may also have borrowing relationships with other related branches or affiliated companies. The head office frequently serves as a primary funding source for the branch, but the level and nature of borrowing may be determined by other factors, including the branch's role in the overall funding strategy of the FBO. For example, an FBO will designate one U.S. branch (generally the branch located in the FBO's home state) to provide the funding to all other U.S. branches. To develop a complete understanding of the borrowing relationship of the branch with the head office and other related offices, the examiner must gain an understanding of the funding strategy of the FBO in the U.S., and should determine the purpose of the borrowing and the reason for the level and flow of funds to various offices.

For FBOs with a controlling interest in a U.S. commercial bank, a borrowing relationship between the commercial bank and offices of the FBO must be explored fully to ensure there are no violations of Sections 23A and 23B of the Federal Reserve Act, inasmuch as the FBO is considered a foreign bank holding company. Additional information on intercompany borrowing and funding relationships is contained in Section 3240, Due From/Due To Related Offices.

FEDERAL FUNDS PURCHASED

The day-to-day use of Federal funds is commonplace among U.S. banking organizations, including branches of FBOs. The most frequent type of Federal funds transaction is unsecured, for one day, and repayable the following business day. The rate is usually determined by overall money market rates and by the available supply of and the demand for funds. Most transactions are in units of \$1 million, although the trading of smaller amounts is fairly common depending upon individual situations. In some instances, where the selling and buying relationship between two financial institutions is a more or less continuing one, a line of credit may be established on a funds-available basis. Although the most common transaction is on an "overnight" unsecured basis, the selling of funds can also be on a secured basis and for longer periods of time such as term Federal funds. While term Federal funds are quite common, the selling of funds on a secured basis is quite rare. Secured borrowing is usually done in instances of severe credit risk and/or perceived default. However, according to the Federal Reserve Act, Section 23A(c)(1), if an FBO owns a domestic, FDICinsured subsidiary bank, any extensions of credit by the domestic bank to the FBO must be done on a secured basis.

INTERBANK DEPOSITS AND BORROWINGS

Interbank deposits are not defined as borrowings for regulatory purposes, and continue to be

Borrowed Funds 3220.1

reflected as deposits. Interbank deposit instruments include certificates of deposits (CDs), Eurodollar deposits or takings (Euro-CDs) and deposits taken under separate borrowing agreements. These funds are generally obtained through the branch's money market deposit taking activities. However, narrowly defining these instruments as deposits instead of borrowings is not universally accepted and, in fact, the negotiable money market CD and Euro-CD are widely recognized as primary borrowing vehicles. Dependence on CDs and Euro-CDs as sources of funds is discussed in Section 3230. Deposit Accounts.

Negotiable CDs and Euro-CDs are generally used by wholesale branches. They consist of deposits over \$100,000 and are not considered core funds. The major distinction between Euro-CDs and negotiable CDs is that Euro-CDs are primarily funds from offshore sources. With more diverse products entering the market, floating rate CDs and floating rate Euro-CDs are becoming more popular.

REPURCHASE AGREEMENTS

Instead of resorting to direct borrowing, a branch may sell assets to another bank or some other party and simultaneously agree to repurchase the assets at a specified time or after certain conditions have been met. Securities and loans are often sold under repurchase agreements to generate temporary working funds. Agreements of this nature are frequently used because the cost of this type of secured borrowing is generally lower than that of unsecured borrowings, such as Federal funds purchased. Repurchase agreements should not be confused with resale agreements (also known as reverse repurchase agreements). The usual terms for sale of securities under a repurchase agreement require that, after a stated period of time, the seller repurchases the same securities at a predetermined price or yield. U.S. government and agency securities are the most common type of instruments sold under repurchase agreements because they are exempt from reserve requirements.

Management should be aware of certain considerations and potential settlement risks associated with repurchase agreements entered into in large volume with institutional investors and/or brokers. If the value of the underlying securities exceeds the price at which the repurchase agreement was sold, the branch could be exposed to the risk of loss in the event that the buyer is unable to perform and return the securities. This possibility is more likely if the securities are physically transferred to the institution or broker with which the branch has entered into the repurchase agreement. For this reason, branches should avoid, if possible, pledging excessive collateral. However, most transactions today do not involve the physical transfer of securities, rather they involve a book entry system which can reduce settlement risk. The branch should obtain sufficient financial information on and analyze the financial condition of those institutions and brokers with whom they engage in repurchase transactions.

Branches engaging in repurchase agreements should include these transactions when calculating their interest rate sensitivity positions. In addition, the degree to which a branch borrows through repurchase agreements should be analyzed with respect to its liquidity needs, and contingency plans should provide for alternate sources of funds in the event of a run-off of repurchase agreement liabilities.

LINES OF CREDIT FROM CORRESPONDENT BANKS

Lines of credit with correspondent banks may be on an advised or unadvised basis. Advised (also know as committed or fee paid) lines of credit provide a reliable source of back-up funding to the branch, in that the correspondent bank is committed to lend under the specified terms of the credit facility. Unadvised lines of credit are not committed facilities and access to such funds can be denied by the correspondent bank. On occasion, branches negotiate loans from their principal correspondent banks. The loans are usually for short periods and may or may not be secured. Lines of credit to finance trade transactions evidenced by letters of credit can result in the correspondent bank financing the branch for an additional period of time, after a sight draft drawn under a letter of credit has been presented at the correspondent bank.

SHORT-TERM DEBT

Short-term borrowings may be found in a branch, both on a direct and indirect basis. Borrowings Borrowed Funds 3220.1

on a direct basis are usually evidenced by promissory notes, or through accounts with the head office or a correspondent bank. Indirect forms of borrowing include notes and trade bills rediscounted; notes, acceptances, import drafts, or trade bills sold with the branch's endorsement or guarantee; notes and other obligations sold subject to repurchase agreements; and acceptance pool participations.

common form of long-term debt is direct term borrowings from correspondent banks. Branches are usually more interested in attracting longterm funds through the U.S. capital markets for their head office than issuing long-term debt for their own utilization.

LONG-TERM DEBT

On an infrequent basis, long-term debt borrowings may be found in a branch. The most

Borrowed Funds Examination Objectives

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Section 3220.2

- To determine if the policies, practices, procedures, and internal controls regarding borrowed funds are adequate.
- To determine if branch officers are operating in conformity with the established guidelines of the head office.
- To determine the scope and adequacy of the internal/external audit function as it relates to borrowed funds.
- 4. To determine compliance with laws and regulations as it relates to borrowed funds.
- To determine if the existing level of borrowed funds is consistent with the branch's activities.
- 6. To determine if the existing rates paid are in line with concurrent market rates.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Borrowed Funds Examination Procedures

Effective date July 1997

Section 3220.3

- If selected for implementation, complete or update the Internal Control Questionnaire.
- Determine if deficiencies noted at the previous examination or by internal/external audits have been addressed by management.
- Determine the purpose of each type of borrowing and whether the branch's borrowing posture is justified in light of its role within the FBO's network and other relevant circumstances.
- Determine if the branch has adequate contingency plans for alternate sources of funds and if these contingency funding lines are periodically tested for availability.
- 5. Prepare, in appropriate report form, and discuss with appropriate management:

- a. The adequacy of written policies regarding borrowings.
- The manner in which branch officers are operating in conformance with established policy.
- c. The existence of any unjustified borrowing practices.
- d. Any violation of laws or regulations.
- Recommended corrective action when policies, practices, or procedures are deficient; violations of laws or regulations exist; or when unjustified borrowing practices are being pursued.
- 6. Update the workpapers with any information that will facilitate future examinations.

Borrowed Funds Internal Control Questionnaire

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Section 3220.4

POLICY

- Has the head office approved a written policy which:
 - a. Outlines the objectives of the branch's borrowings?
 - b. Describes the branch's borrowing philosophy relative to risk considerations, i.e., leverage/growth, liquidity/income?
 - c. Provides for risk diversification in terms of staggered maturities, rather than solely on cost?
 - d. Limits borrowings by amount outstanding, specific type, or total interest expense?
 - e. Limits or restricts execution of borrowings by branch officers?
 - f. Provides a system of reporting requirements to monitor borrowing activity?
 - g. Requires subsequent approval of transactions?
 - h. Provides for review and revision of established policy at least annually?

RECORDS

- 2. Does the branch maintain subsidiary records for each type of borrowing, including proper identification of the obligee and a written confirmation?
- 3. Is the preparation, addition, and posting of the subsidiary borrowed funds records performed or adequately reviewed by persons who do not also:

- a. Handle cash?
- b. Issue official checks and drafts?
- c. Prepare all supporting documents required for payment of debt?
- 4. Are subsidiary records for borrowed funds reconciled with the general ledger accounts at an interval consistent with borrowing activity, and are the reconciling items investigated by persons who do not also:
 - a. Handle cash?
 - b. Prepare or post to the subsidiary records for borrowed funds?
- 5. Has it been determined that borrowings from U.S. bank subsidiaries conform with applicable regulatory restrictions?
- 6. Are corporate resolutions properly prepared as required by creditors and are copies on file for reviewing personnel?
- 7. Are monthly reports furnished to the head office management reflecting the activity of borrowed funds, including amounts outstanding, interest rates, interest paid to date, and anticipated future activity?

CONCLUSION

- Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Borrowed Funds Audit Guidelines

Effective date July 1997

Section 3220.5

- Using an appropriate sampling technique, select items for review of supporting documentation, including terms, balances, and other appropriate details, and request a positive confirmation from the lender. Control all answered confirmations and investigate any reported differences. Include all confirmations in the workpapers and document the disposition of all exceptions or no-replies.
- To the extent appropriate, review collateralized transactions for the sufficiency of security to cover the lender's requirements and ensure that the branch's assets pledged as collateral are clearly identified.
- Examine supporting documents for accuracy and trace applicable entries, including proceeds, to detail records and to the general ledger.
- 4. Test interest computations for accuracy and trace entries to appropriate accounts.
- 5. Examine transactions for adherence with terms of borrowing arrangements.
- Review all borrowings requiring head office approval for appropriate documentation and authorization

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U.S. branches of foreign banking organizations (FBOs) may hold deposits, which represent funds that branch customers have advanced and the branch is obligated to repay on demand, after a specific period of time, or after expiration of some required notice period. Definitions of deposit types (i.e., demand, savings, and NOW accounts and their respective availabilities) are outlined in the Federal Reserve Board's Regulation D and in the instructions to the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002). The nature, type, and level of deposits that a branch may accept is dependent on a variety of factors, including the licensing agency, applicable state restrictions, Federal Deposit Insurance Corporation insurance status, and the limitations imposed based on the type of office, i.e., depository or nondepository office. Management should have policies in place to ensure compliance with all applicable deposit-taking restrictions.

The majority of U.S. branches of FBOs do not maintain FDIC insurance and are therefore subject to relevant notification requirements described in the Federal Deposit Insurance-Insured and Uninsured Branches section of this manual. These wholesale branches generally may accept deposits over \$100,000 or from U.S. nonresidents. Branches, however, can accept deposits of less than \$100,000 from residents provided the branch's total retail deposits do not exceed 1 of its total deposits. Refer to FDIC Rules and Regulations Part 346 for additional information. Licensing agencies may apply additional deposit-taking restrictions, which should be incorporated into the review's scope. Uninsured branches (non-FDIC-insured) may face legal limitations on deposits but generally have greater flexibility in taking borrowed funds. Examiners should review the documentation supporting deposit and borrowed funds transactions to determine that they are properly identified and reported.

Guidelines applicable to offices with FDICinsured deposits are also available in the section on Federal Deposit Insurance- Insured and Uninsured Branches.

Some branches use private banking departments to gather and retain large deposit bases. For more information on these departments, see the Private Banking section in this manual

REGULATION K SUBPART B SECTION 211.21(B)—CREDIT BALANCES

As defined in Regulation K, Subpart B, Section 211.21(b), Credit Balances, U.S. agencies, as opposed to branches, of FBOs are *not* allowed to accept deposits from U.S. citizens or residents. Agencies may, however, maintain credit balances for U.S. citizens and residents, in addition to taking deposits from foreign residents. Obligations are not considered credit balances unless they meet *all* of the following conditions:

- Arise out of, or are incidental to the exercise of other lawful banking powers, such as the disbursement of loan proceeds, receipt of wire transfer activities, or arise out of letter of credit transactions;
- Serve a specific purpose;
- · Are not solicited from the general public;
- Are not used to pay routine operating expenses in the United States, such as salaries, rent, or taxes;
- Are withdrawn, within a reasonable period of time, after the specific purpose for which they were placed has been accomplished; and
- Are drawn upon in a manner reasonable in relation to the size and nature of the account.

The agency's Report of Assets and Liabilities should correctly show such credit balances.

The remaining discussion applies to those branches that rely heavily on retail deposits as a funding source.

DEPOSIT DEVELOPMENT AND RETENTION PROGRAM

Branch management should adopt and implement a development and retention program for all types of deposits because of competition for funds, the need for most individuals and corporations to minimize idle funds, and the effect of disintermediation (the movement of deposits to other higher- yielding markets) on a branch's deposit base. The review of a branch's deposit development and retention program and the methods used to determine the volatility and composition of the deposit structure are important elements of the examination process. The

3230.1 Deposit Accounts

deposit development and retention program is often included in the funds management policy and should contain a marketing strategy, projections of deposit structure and associated costs, and a formula for comparing results against projections.

Marketing Strategy

In determining its market strategy, management must first consider many factors, including:

- The composition of the market area economic base, especially the countries targeted by the private banking, corporate banking, or correspondent banking departments;
- The ability to employ deposits profitably;
- The adequacy of current operations (staffing and systems) and the location and size of banking quarters relative to its volume of business:
- The degree of competition from banks and nonbank financial institutions and their programs to attract deposit customers; and
- The effects of the local and foreign economies and the monetary and fiscal policies of the local and foreign government on the branch's market area.

After a deposit program is developed, management must continue to monitor those factors and correlate any findings to determine if adjustments are needed. The long term success of any deposit program relates directly to the ability of management to detect the need for change at the earliest possible time.

Deposit Structure and Associated Costs

Management should not only look at deposit growth but also at the characteristics of the deposit structure. Management must be able to determine what percentage of the overall deposit structure is centered in stable or core deposits, in fluctuating or seasonal deposits, and in volatile deposits to properly invest such funds in view of anticipated or potential withdrawals.

It is important that internal reports with information concerning the composition of the deposit structure be provided periodically to both branch and head office management. In analyzing the deposit structure, information gathered by the

various examination procedures should be sufficient to allow the examiner to evaluate the composition of both volatile and core deposits. Management's lack of such knowledge could lead to an asset/liability mismatch, which could cause problems at a later date. Ultimately, the examiner should be satisfied that management has properly planned for the branch's future.

Examiners must analyze the present and potential effect deposit accounts have on the financial profile of the branch, particularly with regard to the quality and scope of management's planning. The examiner's efforts should be directed to the various types of deposit accounts that the branch uses for its funding base. The examiners assigned to funds management and to analytical review of the branch's income and expenses should be informed of any significant change in interest-bearing deposit account activity.

For branches with a significant deposit base, interest paid on deposits can represent the largest expense to the branch. Additional costs associated with deposits include general operating costs, promotional and advertising costs, and changes in required reserves. As a result, interest-bearing deposit accounts employed in a marginally profitable manner could have significant and lasting effects on branch earnings. Refer to the Income and Expense Section of this manual for additional information.

Comparing Results to Projections

Management should have a formula in place for comparing results against projections. Projections should be periodically reviewed and updated throughout the fiscal year. Actual results should be periodically compared to projections and material variances should be identified and reviewed by management. Typically, the branch's annual budget will include projections for deposits and associated costs. Refer to the Income and Expense section of this manual for additional information on comparing actual results to those projected.

SPECIAL DEPOSIT-RELATED ISSUES

The examiner should keep in mind the following issues during an examination to ensure that the branch is in compliance, where applicable.

Deposit Accounts 3230.1

Abandoned Property Law

State abandoned property laws are generally called escheat laws. Although escheat laws vary from state to state, they normally require a branch to remit the proceeds of any deposit account to the state treasurer when:

- The deposit account has been dormant for a certain number of years; and
- The owner of the account cannot be located.

Service charges on dormant accounts should bear a direct relationship to the cost of servicing the accounts to ensure that the charges are not excessive. Management should have policies and procedures in place to review and document the basis on which service charges on dormant accounts are assessed. There have been occasions when, because of excessive charges, there were no proceeds to remit at the time the account became subject to escheat requirements and courts have required banks to reimburse the state. (Refer to the discussion on dormant accounts in the subsequent Potential Problem Areas section.)

Bank Secrecy Act

Examiners should be aware of the Bank Secrecy Act when examining the deposit area and follow up on any unusual activities or arrangements noted. The Act was implemented by the Treasury Department's Financial Recordkeeping and Reporting of Currency and Foreign Transactions Regulation. For further information, see the Federal Reserve's Bank Secrecy Act Manual, Section 208.14 of the Federal Reserve's Regulation H, and other supervisory material. The Federal Reserve's Bank Secrecy Act Manual also includes information on "Know Your Customer" guidelines.

Banking Hours and Processing of Demand Deposits

The Uniform Commercial Code (UCC) allows a bank or branch to establish a banking day cut-off hour of 2:00 p.m. or later for the handling of items received for deposit or presented for payment (UCC 4-108). A banking day is defined as the part of a day on which the bank or branch is open to the public for substantially all of its

banking functions (UCC 4-104(a)(3)). For branches with retail deposit-taking activities, a banking day generally includes, at a minimum, operation of a teller window and the bookkeeping and loan departments. Items received on a nonbanking day or after the cut-off hour on a banking day may be processed as if received on the following banking day.

A branch that violates the cut-off hour could be subject to civil liability for not performing its duties under other provisions of the UCC (see UCC 4-202, 4-213, 4-214, 4-301, and 4-302).

Foreign Currency Deposits

Branches are permitted to accept deposits denominated in foreign currency. Branches should notify customers that such deposits are subject to foreign exchange risk. The branch converts such accounts to the U.S. dollar equivalents for reporting to the Federal Reserve. Examiners should verify that all reports are in order and evaluate the branch's use of such funds and management of the accompanying foreign exchange risk. Foreign currency denominated accounts are not subject to the requirements of Regulation CC, Availability of Funds and Collection of Checks. For additional information, examiners may refer to the Federal Reserve's supervisory guidance letter, SR-90-3 (IB), Foreign (Non-U.S.) Currency Denominated Deposits Offered at Domestic Depository Institutions.

International Banking Facilities

An International Banking Facility (IBF) is a set of asset and liability accounts segregated on the books of a branch. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. When examining an IBF, the examiner should follow the special examination procedures in the International Banking Facility section of this manual.

Reserve Requirements

Under the Monetary Control Act of 1980 and the Federal Reserve's Regulation D, Reserve 3230.1 Deposit Accounts

Requirements of Depository Institutions, branches are subject to reserve requirements in the following instances:

- It is an insured branch, and its parent foreign bank has total worldwide consolidated bank assets in excess of \$1 billion; or
- It is an insured branch, and is controlled by a foreign company or by a group of foreign companies that own or control foreign banks that in the aggregate have total worldwide consolidated bank assets in excess of \$1 billion; or
- It is a branch that is eligible to apply to become an insured bank under section 5 of the Federal Deposit Insurance Act.

For reserve requirement purposes, there are two categories of deposits: transaction accounts and nontransaction accounts. Refer to the Federal Reserve's Regulation D and the FFIEC 002 instructions for specific definitions of the various types of deposits. Branches may choose to maintain reserves for discount window access.

POTENTIAL PROBLEM AREAS

The following paragraphs discuss the types of deposit accounts and related activities that have above-average risk and, therefore, require the examiner's special attention.

Branch-Controlled Deposit Accounts

Branch-controlled deposit accounts, such as suspense, official checks, cash collateral, dealer reserves, and undisbursed loan proceeds are used to perform many necessary banking functions. However, the absence of sound administrative policies and adequate internal controls regarding these accounts can cause significant loss to the branch. To ensure that such accounts are properly administered and controlled, branch and head office management must ensure that operating policies and procedures are in effect that establish acceptable purpose and use; appropriate entries; controls over posting entries; and the length of time an item may remain unrecorded, unposted, or outstanding. Internal controls that limit employee access to branchcontrolled accounts, determine the responsibility for frequency of reconcilement, discourage

improper posting of items, and provide for periodic internal supervisory review of account activity are essential to efficient deposit administration.

The deposit suspense account is used to process unidentified, unposted, or rejected items. Characteristically, items posted to such accounts clear in one business day. The length of time an item remains in control accounts often reflects on the branch's operational efficiency. This deposit type has a higher risk potential because the transactions are incomplete and require manual processing to be completed. Due to the need for human interaction and the exception nature of these transactions, the possibility of misappropriation exists.

Official checks are a type of demand deposit, and include bank checks, cashier's checks, expense checks, interest checks, dividend pavment checks, certified checks, and money orders. Official checks reflect the branch's promise to pay a specified sum upon presentation of such checks. Because accounts are controlled and reconciled by branch personnel, it is important that appropriate internal controls are in place to ensure that account reconcilement is segregated from check origination. Operational inefficiencies, such as unrecorded checks that have been issued, can result in a significant understatement of the branch's liabilities. Misuse of official checks may result in substantial losses through theft.

Cash collateral, undisbursed loan proceeds, and various loan escrow accounts are also sources of potential loss. The risk lies in inefficiency or misuse if the accounts become overdrawn or if funds are diverted for other purposes, such as the payment of principal or interest on branch loans. Funds deposited to these accounts should be used only for their stated purposes.

Brokered Deposits

Brokered deposits represent funds the branch obtains, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts. Thus, brokered deposits include both those in which the entire beneficial interest in a given branch deposit account or instrument is held by a single depositor and those in which the deposit broker pools funds from more than one investor for deposit in a given branch deposit account.

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A small or medium-sized branch's dependence on the deposits of customers who reside outside of or conduct their business outside of the branch's normal service area should be closely monitored by branch and head office management, and analyzed by the examiner. Such deposits may be the product of personal relationships or good customer service; however, large out-of-area deposits are sometimes attracted by liberal credit accommodations or by offering significantly higher interest rates than competitors offer. Deposit growth due to liberal credit accommodations generally proves costly in terms of the credit risks taken relative to the benefits received from corresponding deposits, which may be less stable. Deposit development and retention policies should recognize the limits imposed by prudent competition and the branch's service area.

Banking organizations have historically relied to a limited extent upon funds obtained through deposit brokers to supplement their traditional funding sources. A concern regarding the activities of deposit brokers is that the ready availability of large amounts of funds through the issuance of such obligations undercuts market discipline, particularly in insured depository institutions. To compensate for the high rates typically offered for brokered deposits, institutions holding them tend to seek assets that carry commensurately high yields. These assets can often involve excessive credit risk or cause the branch to take on undue interest-rate risk through a mismatch in the maturity of assets and liabilities.

In light of these concerns, certain restrictions on the use of brokered deposits were developed under section 301 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which apply to federally-insured branches. Section 301 of FDICIA amended section 29 of FDIA to prohibit undercapitalized institutions from accepting funds obtained, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts. Adequately capitalized institutions may accept such funds only if they first obtain a waiver from the FDIC, while well-capitalized institutions may accept such funds without restriction. Refer to FDIC regulations and guidelines for information on how these requirements are applied to federally-insured branches. Each examination should include a review for compliance with the FDIC's limitations on the acceptance of brokered deposits and guidelines on interest payments.

The use of brokered deposits should be reviewed during all on-site examinations, even for those institutions not subject to the FDIC's restrictions. In light of the potential risks accompanying the use of brokered deposits, the examination should focus on:

- The rate of growth and the credit quality of the loans or investments funded by brokered deposits;
- Whether brokered funds are in turn sold to branch customers;
- The corresponding quality of loan files, documentation, and customer credit and deposit information;
- The ability of branch management to adequately evaluate and administer these credits and deposits and manage the resulting growth;
- The degree of interest-rate risk involved in the funding activities and the existence of a possible mismatch in the maturity or ratesensitivity of assets and liabilities;
- The composition and stability of the deposit sources and the role of brokered deposits in the branch's overall funding position and strategy; and
- The effect of brokered deposits on the branch's risk standing and whether or not the use of brokered deposits constitutes an unsafe and unsound banking practice.

Check Kiting

Check kiting occurs when a depositor with accounts at two or more banks draws checks against the uncollected balance at one bank to take advantage of the float (i.e., the time required for the bank of deposit to collect from the paying bank); and the depositor initiates the transaction with the knowledge that sufficient collected funds will not be available to support the amount of the checks drawn on all of the accounts.

The key to this deceptive practice, the most prevalent type of check fraud, is the ability to draw against uncollected funds. However, drawing against uncollected funds in and of itself does not necessarily indicate kiting. Kiting only occurs when the aggregate amount of drawings exceeds the sum of the collected balances in all accounts. Nevertheless, because drawing against

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uncollected funds is the initial step in the kiting process, management should closely monitor this activity. The requirements of Regulation CC, Availability of Funds and Collection of Checks, increased the risk of check kiting and should be addressed by management in the branch's policies and procedures.

By allowing a borrower to draw against uncollected funds, the branch is extending credit that should be subject to an appropriate approval process. Accordingly, management should promptly investigate unusual or unauthorized activity because the last bank to recognize check kiting and pay on the uncollected funds suffers the loss. Check kiting is illegal, and all suspected or known check kiting operations should be reported pursuant to established regulatory policy. Branch management should maintain internal controls to preclude loss from kiting and the examiner should remember that, in most cases, kiting is not covered under Blanket Bond Standard Form 24.

Delayed Disbursement Practices

Although Regulation CC, Availability of Funds and Collection of Checks, stipulates time frames for funds availability and return of items, delayed disbursement practices (also known as remote disbursement practices) can present certain risks, especially concerning cashier's checks, which have next-day availability. Delayed disbursement is a common cash management practice that consists of arrangements designed to delay the collection and final settlement of checks by drawing checks on institutions located substantial distances from the payee or on institutions located outside the Federal Reserve cities when alternate and more efficient payment arrangements are available. Such practices deny depositors the availability of funds to the extent that funds could otherwise have been available earlier. A check drawn on an institution remote from the payee often results in increased possibilities of check fraud and in higher processing and transportation costs for return items.

Delayed disbursement arrangements could give rise to supervisory concerns because a branch may unknowingly incur significant credit risk through such arrangements. The remote location of institutions offering delayed disbursement arrangements often increases the collection time for checks by at least a day or more. The primary risk is payment against uncollected funds, which could be a method of extending unsecured credit to a depositor. Absent proper and complete documentation regarding the creditworthiness of the depositor, paying items against uncollected funds could be considered an unsafe or unsound banking practice. Furthermore, such loans, even if properly documented, might exceed the branch's prudential lending limit, if applicable, for loans to one customer.

Examiners should routinely review a branch's practices in this area to ensure that such practices are conducted prudently. If undue or undocumented credit risk is disclosed or if lending limits are exceeded, appropriate corrective action should be taken.

Deposit Sweep Programs/Master Note Arrangements

Deposit sweep programs/master note arrangements (sweep programs) can be implemented on a branch level or on a FBO level. On a branch level, these sweep programs exist primarily to facilitate cash management needs of branch customers, thereby retaining customers who might otherwise move their account to an entity offering higher yields. On a FBO level, the sweep programs are maintained with customers at the branch level and the funds are upstreamed to the FBO as part of its overall funding strategy. Sweep programs use an agreement with the branch's deposit customers (typically corporate accounts) that permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight investments. These obligations include such instruments as commercial paper, program notes, and master note agreements.

For insured branches, the disclosure agreement regarding the sale of these types of nondeposit debt obligations should include a statement indicating that these instruments are not federally insured deposits or obligations of or guaranteed by an insured depository institution. In addition, insured branches and their related parties and subsidiaries that have issued or plan to issue nondeposit debt obligations should not market or sell these instruments in any public area of the branch where retail deposits are accepted, including any lobby area of the branch. This requirement exists to convey the impression or understanding that the purchase of such Deposit Accounts 3230.1

obligations by retail depositors of the federallyinsured branch can, in the event of default, result in losses to individuals who believed they had acquired federally-insured or guaranteed obligations.

Branch Policies and Procedures

Banking organizations with sweep programs should have adequate policies, procedures, and internal controls in place to ensure that the activity is conducted in a manner consistent with safe and sound banking principles and in accordance with all banking laws and regulations. Branch policies and procedures should further ensure that deposit customers participating in a sweep program are given proper disclosures and information. When a sweep program is used as part of a funding strategy for a FBO or a nonbank affiliate, examiners should ensure that liquidity and funding strategies are carried out in a prudent manner.

Application of Deposit Proceeds

In view of the extremely short-term maturity of most sweep accounts, branches are expected to exercise great care when investing the proceeds. Branches, from which deposit funds are swept, have a fiduciary responsibility to their customers to ensure that such transactions are conducted properly. Appropriate uses of the proceeds of deposit sweep funds are limited to short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal. Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity prob-

lems and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

Funding Strategies

A key principle underlying the Federal Reserve's supervision of banking organizations is that FBOs should operate in a way that promotes the soundness of their U.S. operations. FBOs are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their U.S. operations. Any funding strategy should maintain an adequate degree of U.S. dollar liquidity at the U.S. operation and the FBO, if appropriate. Branch management should avoid, to the extent possible, allowing sweep programs to serve as a source of funds for inappropriate uses at the FBO or at an affiliate. Concerns exist in this regard, because funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in the FBO's viability.

Funding Programs

In developing and carrying out funding programs, FBOs should give special attention to the use of overnight or extremely short-term liabilities because a loss of confidence in the issuing organization could lead to an immediate funding problem. Thus, FBOs relying on overnight or extremely short-term U.S. dollar funding sources, should maintain a sufficient level of superior-quality assets that can be immediately liquidated or converted to cash with minimal loss, at least equal to the amount of those U.S. dollar funding sources.

Dormant Accounts

A dormant account is one in which customeroriginated activity has not occurred for a predetermined period of time. Because of this inactivity, dormant accounts are frequently the target of malfeasance and should be carefully controlled by a branch. Branch management should establish standards that specifically outline the

^{1.} Some banking organizations have interpreted language in a 1987 letter signed by the Secretary of the Board as condoning funding practices that may not be consistent with the principles set forth in a subsequent supervisory letter dated September 21, 1990, as well as with prior Board rulings. The 1987 letter involved a limited set of facts and circumstances that pertained to a particular banking organization; it did not establish or revise Federal Reserve policies on the proper use of the proceeds of short-term funding sources. In any event, banking organizations should no longer rely on the 1987 letter to justify the manner in which they use the proceeds of sweep programs. Banking organizations employing sweep programs are expected to ensure that these programs conform with the policies contained in this manual section.

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branch's policy for the effective control of dormant accounts, addressing:

- The types of deposit categories that could contain dormant accounts, including demand, savings, and official checks;
- The length of time without customer-originated activity that qualifies an account to be identified as dormant:
- The controls exercised over the accounts and their signature cards, that is, prohibiting release of funds by a single branch employee; and
- The follow-up by the branch when ordinary branch mailings, such as account statements and advertising flyers, are returned to the branch because of changed addresses or other reasons for failure to deliver.

Employee Deposit Accounts

Historically, examiners have discovered various irregularities and potential wrongdoing through reviews of employee deposit accounts. As a result, if employees are permitted to maintain accounts at the branch, branch policy should establish standards that segregate or specially encode employee accounts and encourage periodic internal supervisory review. In light of these concerns, examiners should review related branch procedures and practices, taking appropriate measures when warranted.

Overdrafts

The size, frequency, and duration of deposit account overdrafts are matters that should be governed by branch policy and controlled by adequate internal controls, practices, and procedures. Overdraft charges should be significant enough to discourage abuse. Overdraft authority should be approved in the same manner as lending authority and should never exceed the employee's lending authority. Systems for monitoring and reporting overdrafts should emphasize a secondary level of administrative control that is distinct from other lending functions so account officers, who may be less than objective, do not allow influential customers to exploit their overdraft privileges. An examiner should also be aware that Regulation O addresses the payment of overdrafts to executive officers of a federally-insured branch. It is the responsibility

of branch management, with oversight from head office, to review overdrafts as they would any other extension of credit. In most cases, overdrafts outstanding for more than 30 days, which lack mitigating circumstances, should be considered for charge-off.

Payable-Through Accounts

A payable-through account is an accommodation offered to a correspondent bank or other customer by a U.S. banking organization, whether they have a domestic or foreign charter, whereby drafts drawn against client subaccounts at the correspondent are paid upon presentation by the U.S. banking institution. The subaccount holders of the payable-through bank are generally non-U.S. residents or owners of businesses located outside of the United States. Usually, the contract between the U.S. banking organization and the payable-through bank purports to create a contractual relationship, solely between the two parties to the contract. Under the contract, the payable-through bank is responsible for screening subaccount holders and maintaining adequate records with respect to such holders. The examiner should be aware of the potential for money laundering through payable-through accounts and should refer to the Bank Secrecy Act Manual for examination procedures.

Zero-Balance Accounts

Zero-balance accounts (ZBAs) are demand deposit accounts, used by a branch's corporate customers, through which checks or drafts are received for either deposit or payment. The total amount received on any particular day is offset by a corresponding debit or credit to the account before the close of business, to maintain the balance at or near zero. ZBAs enable a corporate treasurer to effectively monitor cash receipts and disbursements. For example, as checks arrive for payment, they are charged to a ZBA, with the understanding that funds to cover the checks will be deposited before the end of the banking day. Several common methods used to cover checks include:

- · Wire Transfers;
- Depository Transfer Checks—a bank-prepared payment instrument used to transfer money

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from a corporate account in one bank to another bank:

- Concentration Accounts—a separate corporate demand deposit account at the same bank used to cover deficits or channel surplus funds relative to the ZBA; and
- Extended Settlement—a cash management arrangement that does not require the corporate customer to provide same-day funds for payment of its checks.

Because checks are covered before the close of business on the day they arrive, the branch's exposure is not reflected in the financial statement. The branch, however, assumes risk by paying against uncollected funds, thereby creating unsecured extensions of credit during the

day (referred to as a daylight overdraft between the account holder and the branch). If these checks are not covered, an overdraft occurs, which will be reflected on the branch's financial statement.

The absence of prudent safeguards and a lack of full knowledge of the creditworthiness of the depositor may expose the branch to large, unwarranted, and unnecessary risks. Moreover, the magnitude of unsecured credit risk may exceed prudent limits. Examiners should routinely review cash management policies and procedures to ensure that branches do not engage in unsafe and unsound banking practices, making appropriate comments in the report of examination, as necessary.

Deposit Accounts Examination Objectives

Effective date July 1997

Section 3230.2

- To determine if the policies, practices, procedures, and internal controls regarding deposit accounts are adequate.
- 2. To determine if branch officers and employees are operating in conformance with the branch's established guidelines.
- 3. To evaluate the deposit structure and determine its characteristics and volatility.
- 4. To determine the scope and adequacy of the audit function.
- 5. To determine compliance with applicable laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Deposit Accounts

Examination Procedures

Effective date July 1997

 Maturity reports d. For deposit sweep programs/master note

Section 3230.3

- management. 2. Check applicable restrictions on the nature, type, and level of deposits that can be
- maintained by the branch. 3. If selected for implementation, complete the

1. Determine it deficiencies noted at the pre-

vious examination or by internal/external

audits have been adequately addressed by

- 4. In conducting an examination, the examiner should use available branch copies of printouts plus transactions journals, microfiche, or other visual media to minimize expense to the branch. However, if copies of these reports are not available, the examiner should determine and request the information necessary to complete the examination procedures and, if required, the internal control questionnaire. Obtain or prepare, as applicable, the reports indicated below, which are used for a variety of purposes, including the assessment of deposit volatility and liquidity, adequacy of internal controls, verification of information contained on required regulatory reports, and assessment of loss.
 - a. For demand deposits and other transaction accounts:
 - · Trial balance
 - Overdrafts
 - Unposted items
 - Nonsufficient funds (NSF) report
 - · Dormant accounts
 - · Uncollected funds
 - Due to banks
 - · Trust department funds
 - · Significant activity
 - Suspected kiting report
 - · Matured certificates of deposits without an automatic renewal feature
 - · Large balance report
 - b. For official checks:
 - Trial balance(s)
 - c. For time deposits:
 - Trial balance(s)
 - Unposted items
 - · Dormant Accounts
 - · Trust department funds
 - · Large balance report
 - Money market accounts
 - · Negotiable certificates of deposits

- arrangements:
 - List individually by deposit type and amount
- e. For brokered deposits:
 - · List individually by deposit type, including amount and rate
- f. For foreign currency deposits:
 - List of accounts and currency type
- g. For employee deposit accounts:
 - · List individually by deposit type, including amount and rate
 - · Overdrafts
 - · Monthly account activity, including dollar and transaction volume
- 5. If an agency, for credit balances:
 - a. Review the agency's policy to ensure compliance with Subpart B Section 211.21(b) of Regulation K dealing with credit balances.
 - b. Determine that controls are in place to monitor compliance with the regulation.
 - c. Select a sample of credit balances and review transaction activity to determine if such balances are being used in accordance with the regulation.
- 6. Review the reconcilements of all types of deposit accounts and verify the balances to department controls and the general ledger,
 - a. Determine if reconciliation items are legitimate and if they clear within a reasonable time frame.
 - b. Retain custody of all trial balances, only if necessary and practical.
- 7. Test documentation on the underlying transactions reported as borrowed funds to ensure that these do not better fit the definition of deposits. Refer to the Borrowed Funds section of this manual and appropriate sections of the Board's Regulation D for additional guidance. If determined to be deposits, include such transactions in the review of deposits.
- 8. Review the reconciliation process for branch controlled accounts, such as official checks and escrow deposits, by:
 - a. Determining if reconciling items are legitimate and if they clear within a reasonable time frame.

- Scanning activity in such accounts to determine the potential for improper diversion of funds for various uses, such as:
 - · Political contributions
 - Loan payments (principal or interest)
 - · Personal use
- c. Determine if checks are being processed before their related credits.
- Review the branch's operating procedures and reconciliation process relative to suspense accounts and determine if:
 - a. The disposition of unidentified items is completed in a timely fashion.
 - b. Reports are generated to periodically inform management of the type, age, and amounts of items in such accounts.
 - Employees responsible for clearing suspense account times are not shifting the items between accounts.
- Evaluate the effectiveness of the policies, procedures, and management's reporting methods regarding overdrafts and drawings against uncollected funds.
 - a. Concerning overdrafts, determine if:
 - Officer-approval limits have been established
 - A formal system of review and approval is in effect
 - b. Ascertain the existence of formal overdraft protection, and, if it exists:
 - Obtain a master list of all depositors with formal overdraft protection
 - Obtain a trial balance indicating advances outstanding and compare it with the master list to ensure compliance with approved limits
 - Cross-reference the trial balance or master list to examiner loan line sheets
 - Review credit files on significant formal agreements not cross-referenced above
 - c. Concerning drawings against uncollected funds, determine if:
 - The uncollected funds report reflects balances as being uncollected until they are actually received
 - Management is comparing reports of significant changes in balances and activity volume to uncollected funds reports
 - Management knows the reasons why a depositor is frequently drawing against uncollected funds
 - · A reporting system to inform senior

- management of significant activity in this area has been instituted
- Appropriate employees clearly understand the mechanics of drawing against uncollected funds and the risks involved, especially in the area of potential check kiting operations
- d. Upon completing steps 10.a., 10.b., and 10.c., the examiner should:
 - Cross-reference overdraft and uncollected funds reports to examiner loan line sheets;
 - For those depositors not cross referenced in the preceding step, review the credit files of depositors with significant overdrafts, if available, or the credit files of depositors who frequently draw significant amounts against uncollected funds;
 - Request management to charge off overdrafts deemed to be uncollectible by examiners; and
 - Submit a list of the following items to the appropriate examiner:
 - Overdrafts considered loss, indicating borrower and amount.
 - Aggregate amounts overdrawn 30 days or more, for inclusion in past due statistics.
- Review the branch's deposit development and retention policy, which is often included in the funds management policy.
 - Determine if the policy addresses deposit structure and related interest costs, including the percentages of time deposits and demand deposits of:
 - · Individuals
 - · Corporations
 - Determine if the policy requires periodic reports to management, comparing the accuracy of projections with results.
 - Assess the reasonableness of the policy and ensure that it is routinely reviewed by management.
- 12. If a deposit sweep program/master note arrangement exists, review for approval of related policies and procedures by head office management.
- 13. For branches with deposit sweep programs/ master note arrangements (sweep programs), compare practices for adherence to approved policies and procedures, including a review of:
 - The purpose of the sweep program: is it strictly a customer accommodation trans-

- action or is it intended to fund certain assets at the foreign banking organization (FBO) level or at an affiliate? Review funding transactions in light of liquidity and funding needs of the FBO by referring to the manual section on Funds Management and Liquidity.
- b. The eligibility requirements used by the branch to determine the types of customers and accounts that may participate in a sweep program, including:
 - A list of customers participating in sweep programs, with dollar amounts of deposit funds swept on the date of examination.
 - The name of the recipient(s) of swept funds and:
 - If an affiliate of the branch (i.e., FBO), a schedule of the instruments into which the funds were swept, including the effective maturity of these instruments.
 - If an unaffiliated third party, determine if the branch adequately evaluates the third party's financial condition at least annually. Verify if a fee is received by the branch for the transaction and, if so, that it is disclosed in customer documentation.
- c. Whether the proceeds of sweep programs are invested only in short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.
- d. Whether the branch has issued or plans to issue nondeposit debt obligations in any public area of the branch where retail deposits are accepted, including any lobby area of the branch.
- e. Completed sweep program documents to determine if:
 - In the case of federally-insured branches, signed documents boldly disclose that the instrument into which deposit funds will be swept is not insured by the FDIC and is not an obligation of or guaranteed by the branch
 - Proper authorization for the instrument exists between the customer and an authorized representative of the branch.

- Signed documents properly disclose the name of the obligor and type of instrument into which the depositor's funds will be swept. If funds are being swept into U.S. government securities held by the branch or FBO, verify that adequate confirmations are provided to customers in accordance with the Government Securities Act of 1986. (This Act requires that all transactions subject to a repurchase agreement be confirmed in writing at the end of the day of initiation and that the confirmation covers specific securities. If any other securities are substituted that result in a change of issuer, maturity date, par amount, or coupon rate, another confirmation must be issued at the end of the day during which the substitution occurred. Because the confirmation or safekeeping receipt must list specific securities, pooling of securities for any type of sweep program involving government securities is not permitted. Additionally, if funds are swept into other instruments, similar confirmation procedures should be applied.)
- Conditions of the sweep program are stated clearly, including the dollar amount (minimum or maximum amounts and incremental amounts), time frame of sweep, time of day sweep transaction occurs, fees payable, transaction confirmation notice, pre-payment terms, and termination notice.
- The length of any single transaction under sweep programs in effect has not exceeded 270 days and the amount is \$25,000 or more (as stipulated by SEC policy). Ongoing sweep program disclosures should occasionally be sent to the customer to ensure that the terms of the program are updated and the customer understands the terms.
- f. In the case of federally-insured branches, samples of advertisements (newspaper, radio and television spots, etc.) by the branch for sweep programs to determine if the advertisements:
 - Boldly disclose that the instrument into which deposit funds are swept is not insured by the FDIC and is not an obligation of, or guaranteed by, the branch.

- Are not enclosed with insured deposit statements mailed to customers.
- g. Whether the sweep program has had a negative effect on branch liquidity or has the potential to undermine public confidence in the branch. Additionally:
 - Review the branch's Federal funds and other borrowing activities to ascertain whether borrowings appear high. If so, compare the branch's borrowing activity with daily balances of aggregate sweep transactions on selected dates, to see if a correlation exists.
 - If sweep activity is significant, compare the rates being paid on swept deposits with the yields received on the invested funds and with the rates on other overnight funding instruments, such as fed funds, to determine if they are reasonable.
- 14. Forward the following to the examiner assigned to Funds Management and Liquidity:
 - a. The amount of any deposit decline or deposit increase anticipated by management (the time period will be determined by the examiner performing liquidity and funds management).
 - A listing by name and amount of any depositor controlling a significant percentage of total deposits.
 - A maturity schedule of certificates of deposit, detailing maturities within the next 30, 60, 90, 180, and 360 days.
 - d. An assessment of the overall characteristics and volatility of the deposit structure.
- 15. Assess the volatility and the composition of the branch's deposit structure.
 - a. Review the list of time certificates of deposit of \$100,000 or more and related management reports to determine:
 - The aggregate dollar volume of bearer CDs, if significant.
 - The aggregate dollar volume of accounts of depositors by country.
 - If the branch is paying competitive rates on CDs.
 - The aggregate dollar volume of money market CDs with interest rates higher than current publicly quoted rates within the industry, if significant.
 - The dollar amount of brokered CDs, if any.

- b. Select, at a minimum, the 10 largest accounts to determine if the retention of those accounts depends on:
 - Criticizable loan relationships.
 - Liberal service accommodations, such as permissive overdrafts and drawings against uncollected funds.
 - · Interbank correspondent relationships.
 - Deposits obtained as a result of special promotions.
 - · A recognizable trend with respect to:
 - Frequent significant balance fluctuations.
 - Seasonal fluctuations.
 - Nonseasonal increases or decreases in average balances.
- c. Elicit management's comments to determine, to the extent possible:
 - The potential renewal of large CDs that mature within the next 12 months.
 - If a significant dollar volume of accounts is concentrated in customers engaged in a single business or industry.
- 16. Test for compliance with the applicable laws and regulations listed below by performing the following procedures:
 - a. For federally-insured branches, Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks:
 - Review the overdraft listing to ensure that the branch has not paid an overdraft on any account of an executive officer, unless the payment is made according to:
 - A written, preauthorized, interestbearing extension of a credit plan providing for a method of repayment or
 - A written, preauthorized transfer from another account of that executive officer.

Payment of inadvertent overdrafts in an aggregate amount of \$1,000 or less is not prohibited, provided the account is not overdrawn more than five business days and the executive officer is charged the same fee charged other customers in similar circumstances. Overdrafts are extensions of credit and must be included when considering each insider's lending limits and other extensions of credit restrictions and the aggregate lending limit for all outstand-

- ing extensions of credit by the branch to all insiders and their related interests.
- b. 12 USC 1972(2), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks:
 - Review the overdraft listing to ensure that no preferential overdrafts exist from the branch under examination to the executive officers, directors, or principal shareholders of its correspondent bank.
- c. Section 301 of the Federal Deposit Insurance Corporation Improvement Act of 1991. Refer to the section on Federal Deposit Insurance-Uninsured and Insured Branches of this manual for procedural guidance.
- d. Regulation D (12 CFR 204), Reserve Requirements of Depository Institutions:
 - Review the accuracy of the deposit data used in the branch's reserve requirement calculation for the exami-

- nation date. In cases where a branch issues nondeposit, uninsured obligations that are classified as deposits in the calculation of reserve requirements, examiners should determine if these items are properly categorized.
- e. Local escheat laws:
 - Determine if the branch is adhering to the local escheat laws with regard to all forms of dormant deposits, including official checks.
- 17. If applicable, determine if the branch is appropriately monitoring and limiting the foreign exchange risk associated with foreign currency deposits.
- 18. Discuss overall findings with branch management and prepare report comments on:
 - a. Policy deficiencies.
 - b. Noncompliance with policies.
 - c. Weaknesses in supervision and reporting.
 - d. Violations of laws and regulations.
 - e. Possible conflicts of interest.

Deposit Accounts

Internal Control Questionnaire

Effective date July 1997

Section 3230.4

OPENING DEPOSIT ACCOUNTS

- Are the opening of new accounts and access to unused new account records and certificate of deposit (CD) forms handled by an employee who is not a teller or who cannot make internal entries to customer accounts or general ledger?
- 2. Does the branch have a written "Know Your Customer" policy?
 - a. Do new account applications require sufficient information to clearly identify the customer?
 - b. Are "starter" checks issued only after verification of data on new transaction account applications?
 - c. Are checkbooks and statements mailed only to the address of record? If not, is a satisfactory explanation and description obtained for any other mailing address (post office boxes, friend or relative, etc.)?
 - d. Are employees responsible for opening new accounts trained to screen depositors for signs of check kiting?
 - e. Will the branch open new accounts with incomplete documentation?
- 3. Are accounts referred to the branch by representative offices? If so, are the representatives employees of the foreign banking organization? Are accounts referred to the branch by other related offices or affiliates? If so, who refers them and why are they booked at the branch? Do these representatives receive "Know Your Customer" training?
- 4. Are new account applications and signature cards reviewed by an officer prior to opening the account?

CLOSING DEPOSIT ACCOUNTS

5. Are signature cards for closed accounts promptly pulled from the active account file and placed in a closed file? Are closed account lists circulated to the appropriate management?

REGULATION K SUBPART B SECTION 211.21(B)—CREDIT BALANCES

- 6. Does the agency have a written policy that addresses credit balances?
- 7. Does the agency refuse to accept deposits from residents of the United States?
- 8. Does the agency's system for monitoring credit balances include a continuing review of checks drawn on the account to ensure that the checks are not being used to pay for routine operating expenses in the United States?
- 9. Do customer deposit files contain sufficient documentation that show the foreign nature of the deposit or foreign citizenship or residency of the customer?
- 10. Are private banking officers or other agency personnel who solicit or open deposit accounts knowledgeable of the regulation's limitations on the agency's deposit-taking powers?

DEPOSIT ACCOUNT RECORDS

- 11. Is the preparation of input and posting of subsidiary demand deposit records performed and/or adequately reviewed by persons who do not also:
 - a. Accept or generate transactions?
 - b. Issue official checks and/or handle funds transfer transactions?
 - c. Prepare or authorize internal entries (return items, reversals, and direct charges, such as loan payments)?
 - d. Prepare supporting documents required for disbursements from an account?
 - e. Perform maintenance on the accounts, such as change of address, stop payments, holds, etc.?
- 12. Does the branch perform reconciliations for each deposit account category by individuals not engaged in accepting or preparing transactions or in data entry to customers' accounts?
- 13. Do periodic reports prepared for management provide an aging of adjustments and differences and detail the status of significant adjustments and differences?

- 14. Are in-process, suspense, interoffice and other accounts related to deposit accounts controlled or closely monitored by persons who do not have posting or reconcilement duties?
- 15. Are periodic reports prepared for management on open items in suspense, in-process, interoffice and other deposit accounts and do the reports include aging of items and the status of significant items?
- 16. Does the branch segregate the deposit account files of:
 - a. Employees and officers?
 - b. The business interests of, or controlled by, employees and officers?
- 17. Are posting and check filing separated from statement preparation?
- 18. Are statements mailed or delivered to all customers, as required by the branch's deposit account agreement and in a controlled environment that precludes any individual from receiving any statement not specifically authorized by the customer or branch policy?

DORMANT ACCOUNTS AND RETURNED MAIL

- 19. Does the branch have formal policies and procedures for the handling of dormant accounts and customers' transaction and interest statements that are returned by the post office as undeliverable? Does the policy:
 - a. Require statements to be periodically mailed on dormant accounts? If so, how often?
 - b. Prohibit the handling of such statements by (1) account officer and (2) other individuals with exclusive control of accounts?
 - c. Require positive action to follow up on obtaining new addresses?
 - d. Require that statements and signature cards for accounts that cannot be contacted (the mail is returned more than once or marked "deceased") be placed into a controlled environment?
 - e. Require the branch to change the address on future statements to the department of the branch (controlled environment) designated to receive returned mail?

- f. Require a written request from the customer and verification of the customer's signature before releasing an account from the controlled environment?
- 20. Are accounts for which contact cannot be reestablished and do not reflect recent activity removed from active files and clearly classified as dormant?
- 21. Before returning a dormant account to active status, are transactions reactivating the account verified, independent confirmations obtained directly from the customer, and approval obtained for an officer who cannot approve transactions on dormant accounts?

INACTIVE ACCOUNTS

- 22. Are demand accounts that have been inactive for one year and time accounts that have been inactive for three years classified as inactive? If not, state the time period.
- 23. Does the branch periodically review the inactive accounts to determine if they should be placed in a dormant status and are decisions to keep such accounts in active files documented?

HOLD MAIL

- 24. Does the branch have a formal policy and procedure for handling statements and documents that a customer requests not to be mailed but will be picked up at a location within the branch? Does the policy:
 - a. Require that statements will not be held by an individual (an account officer, branch manager, bookkeeper, etc.) who could establish exclusive control over entries to and delivery of statements for customer accounts?
 - b. Discourage such arrangements and grant them only after the customer provides a satisfactory reason for the arrangement?
 - c. Require the customer to sign a statement describing the purpose of the request and the proposed times for pick-up and designate the individuals authorized to pick up the statement?
 - d. Require maintenance of signature cards for individuals authorized to pick up statements and compare the authorized signatures to those who sign for statements held for pick-up?

- e. Prohibit the delivery of statements to officers and employees requiring special attention, unless it is part of the formal "hold mail" function?
- 25. Is a central record maintained in a control area that does not originate entries to customers' accounts and identify each "hold mail" arrangement, the designated location for pick-up, and the scheduled pick-up times? Does the control area:
 - a. Maintain current signature cards of individuals authorized to pick up statements?
 - b. Obtain signed receipts showing the date of pick-up and compare the receipts to the signature cards?
 - c. Follow up on the status of statements not picked up as scheduled?
- 26. Does management review activity in "hold mail" accounts that have not been picked up for extended periods of time (for example, one year) and, where there is no activity, place the accounts in a dormant status?

OVERDRAFTS

- 27. Are officer overdraft authorization limits formally established?
- 28. Does the branch require an authorized officer to approve overdrafts?
- 29. Is an overdraft listing prepared daily for demand deposit and time transaction accounts?
- 30. For branches processing overdrafts that are not automatically approved ("pay none" system), is the insufficient funds report circulated among branch officers?
- 31. Are overdraft listings circulated among the officers?
- 32. Are the statements of accounts with large overdrafts reviewed for irregularities?
- 33. Is a record of large overdrafts included in the monthly report to head office management and does it include the overdraft origination date?

UNCOLLECTED FUNDS

34. Does the branch generate a daily report of drawings against uncollected funds for demand deposits and time transaction accounts?

- a. Is the computation of the uncollected funds position based on reasonable check collection criteria?
- b. Can the reports or a separate account activity report reasonably be expected to detect potential kiting conditions?
- c. If reports are not generated for time transaction accounts, is a system in place to control drawings against uncollected funds?
- 35. Do authorized officers review the uncollected funds reports and approve drawings against uncollected funds within established limits?
- 36. Are accounts that frequently appear on the uncollected funds and/or kite suspect reports reviewed, regardless of account balances? (For example, accounts with simultaneous large debits and credits can reflect low balances.)

OTHER MATTERS

- 37. Are account maintenance activities (change of address, status changes, rate changes, etc.) separated from data entry and reconciling duties?
- 38. Do all internal entries, other than service charges, require the approval of appropriate supervisory personnel?
- 39. If not included in the internal/external audit program, are employees' and officers' accounts, accounts of their business interests, and accounts controlled by them periodically reviewed for unusual or prohibited activity?
- 40. For unidentified deposits:
 - a. Are deposit slips kept under dual control?
 - b. Is their disposition approved by an appropriate officer?
- 41. For returned checks, unposted items, and other rejects:
 - a. Are daily listings of such items prepared?
 - b. Are all items reviewed daily and is disposition of items required within a reasonable time period? If so, indicate the time period.
 - c. Are reports prepared for management showing items not disposed of within the established time frames?
- 42. Are accounts with a "hold-balance" status those accounts on which court orders have been placed, those pledged as security to

- customers' loans, those pending the clearing of a large check, and those where the owner is deceased "blocked-out" for transactions unless approved by appropriate management?
- 43. For signature cards on deposit accounts:
 - a. Are procedures in effect to guard against the substitution of false signatures?
 Describe the procedures.
 - b. Are signature cards stored to preclude physical damage?
 - c. Are signatures compared for withdrawals and cashed checks? Describe the procedures.

OFFICIAL CHECKS, MONEY ORDERS, AND CERTIFIED CHECKS

- 44. Are separate general ledger accounts maintained for each type of official check?
- 45. As to the types of checks issued:
 - a. Are multicopy checks and certified check forms used? If not, are detailed registers of disbursed checks maintained?
 - b. Are all checks prenumbered and issued in sequence?
 - c. Is check preparation and issuance separate from recordkeeping?
 - d. Is the signing of checks in advance prohibited?
 - e. Do procedures prohibit issuance of a check before the credit is processed?
- 46. Is the list authorizing branch personnel to sign official checks kept current? Does the list include changes in authorization limits, delete employees who no longer work at the branch, and indicate employees added to the list?
- 47. Are appropriate controls in effect over check signing machines (if used) and certification stamps?
- 48. Are voided checks and certified check forms promptly defaced and filed with paid checks?

- 49. If reconcilements are not part of the overall deposit reconciliation function:
 - a. Are outstanding checks listed and reconciled regularly to the general ledger? If so, how often?
 - b. Is permanent evidence of reconcilements maintained?
 - c. Is there clear separation between preparation of checks, data entry, and reconcilement?
 - d. Are the reconcilements reviewed regularly by an authorized officer?
 - e. Are reconcilement duties rotated on a formal basis in branches where size precludes full separation of duties between data entry and reconcilement?
 - f. Are authorized signatures and endorsements checked by the filing clerk?
- 50. For supplies of official checks:
 - a. Are records of unissued official checks maintained centrally and at each location storing them?
 - b. Are periodic inventories of unissued checks independently performed?
 - c. Do the inventories include a description of all checks issued out of sequence?
 - d. If users are assigned a supply, is that supply replenished on a consignment basis?
- 51. Are procedures in effect to preclude certification of checks drawn against uncollected funds?

CONCLUSION

- 52. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 53. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Deposit Accounts Audit Guidelines

Effective date July 1997

Section 3230.5

It should be noted that some audit guidelines may not be easily implemented due to the foreign residence of many branch customers. Therefore, the examiner should exercise judgement in implementing these guidelines.

- 1. Test the addition of all trial balances and the reconciliation to the general ledger.
- Using appropriate techniques, sample deposits of all types from their respective trial balances and:
 - a. Where appropriate, verify that essential account documentation contains, in a conspicuous manner, disclosure of the accounts' noninsured FDIC status.
 - b. Where necessary, prepare and mail confirmation forms, followed by second requests, to selected depositors.
 - c. Follow up on any no-replies or exceptions and resolve differences.
- 3. For transaction accounts selected in step 2:
 - a. Verify the computation of service charges for at least one account from each type of transaction account selected and trace them to the appropriate income account.
 - Determine, on a test basis, if insufficient funds and overdraft charges are properly collected and trace them to the appropriate income account.
 - c. Determine the reasons for statements noted for "no mail" or "hold for pick up" and examine appropriate authorization signed by the customer.
 - d. Determine if a properly signed authority to charge is in evidence for accounts that have an automatic deduction by the branch.
 - e. Investigate branch-controlled accounts, such as dealers' reserves and cash/ collateral accounts, to determine the validity of entries and of notification procedures to the customer of activity.
 - f. Determine if unidentified funds are properly segregated, that disposition is on a timely basis, and that items are transferred to a dormant account after one year.
 - g. Mail cut-off statements to include debit and credit memos and drafts, and mail an appropriate reconciling form to due to banks accounts selected. Have the reconcilement completed and returned. Inves-

- tigate significant items used to reconcile and follow through to disposition.
- h. Review the reports on drawings against uncollected funds and significant changes to determine possible kiting. Request statements and copies of checks and deposit media to further investigate those selected. If the period for preparing uncollected funds reports is not at least 3 days, perform the following steps:
 - Look at 5 days of reports on uncollected funds, large balances, and significant changes for unusual depositor activity. Select account names and numbers that appear on the reports twice or more and eliminate large depositors who are known to deposit cash or their own checks to corporate clearing accounts.
 - For the remaining accounts, review canceled checks and deposit slips or cash letter items to determine if checks paid and checks deposited are controlled by the same or related parties.
- Determine that collections deposited in escrow funds are properly credited and that debits made against the account are for proper disbursements.
- Review the debit and credit entries made on dormant accounts and determine validity and conformity to branch policy.
- 4. For time deposit accounts selected in step 2:
 - a. Determine the reasons for savings account statements noted for "hold for pick-up" or "no mail" and examine appropriate authorizations signed by the customers.
 - b. Determine that accounts pledged are noted on the trial balance to prevent withdrawal of funds without officer approval.
 - Review the debit and credit entries to dormant accounts and determine validity and conformity to branch policy.
 - d. Verify and detail the written contracts between the branch and its trust department regarding the trust department's time open account.
 - Determine if unidentified funds are properly segregated and if disposition is on a timely basis. Ensure that items are trans-

ferred to a dormant account after one year.

5. For official checks:

- a. If accounts are on computer, reconcile the cut-off statements as of the audit date to bookkeeping totals and run a list of duplicate outstanding checks.
- b. If accounts are manual, run a tape listing of the outstanding checks or the check register and balance to the general ledger totals.
- c. Review the copies of the outstanding checks for unusual items, stale-dated checks or any checks to persons or organizations that may be in violation of the Foreign Corrupt Practices Act or Federal Campaign Acts.
- d. Determine that stale checks are segregated and review the entries to ascertain validity.
- e. Determine that all outstanding checks have been included as liabilities by controlling paid checks for a number of days after the audit has begun and:
 - Indicate any checks paid before the liability was posted.
 - Inspect the paid checks for authorized signatures and endorsements.
- f. Determine if the branch is issuing checks in numerical sequence and make an

- inventory of unissued checks by type. Reconcile the inventory to control ledger and resolve any differences.
- Compare the accounts selected from the last audit to the current trial balance to determine if any of those accounts were closed or, if none were noted, select accounts from the closed account list and send confirmations.
- Review stop-payment orders and compare a representative number to the trial balance to determine if accounts are properly noted.
- Obtain or prepare a schedule showing the accrued interest balances and the deposit balances at each quarter-end since the last audit and investigate significant fluctuations or trends.
- Test interest expense by computing interest expense based on average deposits and interest rates on a quarterly basis. Compare the computed amount to the actual recorded expenses.
- 10. If the branch uses prenumbered CD forms, determine that certificates are issued in numerical order. Inventory the unissued certificates and reconcile the inventory to the control list and resolve any differences.

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Head office and other offices of the foreign banking organization (FBO) frequently serve as a primary funding source for a branch, in which case the branch will be in a net due to position with related offices. This situation is commonly found in a wholesale branch or a branch that is restricted by its license from accepting deposits. Funding for these offices is typically provided by related offices and/or interbank borrowings. A retail branch, on the other hand, may be able to accept deposits and thus be a net provider of funds to related offices or in a net due from position. Examiners will find that the overall level, nature, and significance of the branch's funding relationship with related offices is influenced by a number of factors, including comparative funding costs in the home country versus the United States and the branch's role, if any, in the overall U.S. funding strategy of the FBO. The examiner's role is to evaluate these factors, identify any concerns, and recommend corrective action, if appropriate.

The evaluation of the branch's funding relationship with related parties is part of the overall evaluation of the branch's liquidity position and should thus be conducted jointly. This section provides specific guidance on the interoffice funding aspect of liquidity, which should be supplemented by referring to the Funds Management and Liquidity section of this manual.

To evaluate a funding relationship between a branch and its related offices or affiliates, examiners should begin by reviewing the branch's most recent quarterly call report-Report of Assets and Liabilities (FFIEC 002), the annual assessment of the FBO's combined U.S. operations, and the FBO's annual strength-of-support assessment. A review of recent FFIEC 002 reports will give the examiner information on the branch's historical level and trend in interoffice funding, which should be used in discussions with management on the nature of the branch's future interoffice funding position. Schedule M of the call report summarizes the gross due from/due to position with related parties and shows whether the branch is in a net due to or due from related parties position.

For FBOs with multiple U.S. operations, the U.S. operations assessment should provide information on the past level and flow of funds among its combined U.S. operations, which should also provide a basis for reviewing the

branch's current and future interoffice funding position, if any. In conducting this review, special attention should be paid to any funding relationship between the branch and a U.S. affiliate bank owned or controlled by the FBO. Such a relationship should be scrutinized to verify compliance with Sections 23A and 23B of the Federal Reserve Act. If any apparent violations are noted, they should be referred to the appropriate regulator.

The FBO's annual strength-of-support assessment also provides a basis for reviewing the branch's net due from/due to position. The strength-of-support assessment is an important factor to consider when the branch is in a net due from position. In developing these assessments, the U.S. banking supervisors make determinations about the financial strength of an FBO as well as the adequacy of home country supervision and the overall condition of the home country financial system. The strength-of-support assessment is considered when reviewing branches in a net due from position. (See the Strength-of-Support Assessment for Foreign Banking Organizations section of this manual for more guidance on this subject.) If necessary, the branch may be required to maintain a net due to related parties position or may be subjected to other prudential limitations, including asset maintenance requirements and growth restrictions.

From a supervisory viewpoint, a net due to position is regarded favorably because it provides a cushion for nonrelated depositors and creditors. A net due from position with related parties should be reviewed carefully. The review should consider any information on the underlying assets represented by a net due from related party account. For example, the due from head office account may be used to fund export financing from the home country with payment of the head office account scheduled to come from the receiving party.

In addition to providing funding to related entities, branches may also provide U.S. dollar clearing services. Such transactions would flow through the due from/due to accounts and would consist of checks and other clearing items denominated in U.S. dollars. The branch would, in turn, clear and process the items typically through its U.S. correspondent bank for payment.

The due from/due to accounts may also contain allocations for loan loss reserves and other

contingencies, which would normally flow through earnings and be deducted from capital in a stand-alone operation. Such allocations must be identified and fully explored by the examiners in order to ensure that the branch's financial risks are being covered.

The branch's current period profit and loss is included in the due from/due to subledger accounts with a due to a (credit) balance representing profit and a due from (debit) balance representing a loss. Accumulated but unremitted profit or accumulated but unreimbursed loss also may be included in this account. Note that this situation only applies to the profit and loss segment of the accounts. For example, a very profitable branch could have a net due from related parties position for reasons related to funding but the profit and loss subledger of this account should reveal a due to (profit) balance.

Due from/due to accounts are sometimes used to effect asset transfers from one office to another. Such transfers should be scrutinized and reconciled to ensure propriety. For example, problem loans may be transferred to head office, offshore, or other U.S. and non-U.S. branches. Such transfers should be revealed in the due from/due to accounts, and should be communicated to the examiner-in-charge.

A branch with an asset maintenance requirement will need to keep accurate daily records of the due from/due to related office positions in order to accurately track and report its adherence to the asset maintenance requirement to the regulators. The gross due from/due to related office positions are factored into the computation for the asset maintenance requirement. (See the Asset Maintenance section of this manual for more details on this subject.)

Due From/Due To Related Offices Examination Objectives

Effective date July 1997

Section 3240.2

- To determine if the policies, practices, procedures, and internal controls regarding due from/due to accounts are adequate.
- To determine if branch officers are operating in conformance with the established guidelines from head office.
- To evaluate the nature of all related accounts to determine character, volatility, level, flow of funds, and compliance with appropriate laws
- To determine the scope and adequacy of the audit function with respect to the branch's related parties position.
- To evaluate the branch's net due from/due to position with related parties in relation to the FBO's strength-of-support assessment and the overall assessment of its combined U.S. operations.
- To determine that all due from and due to accounts are reasonably and accurately reported.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Due From/Due To Related Offices

Examination Procedures

Effective date July 1997

Section 3240.3

- Determine the related parties position in accordance with the instructions to the Report of Assets and Liabilities.
- Review the FFIEC 002 report and the appropriate due from/due to schedule and reconcile the figures to the general ledger to ensure accuracy.
- 3. Obtain a listing of any deficiencies noted in the latest review conducted by internal/external auditors with respect to the branch's related parties position, and determine if appropriate corrections have been made.
- 4. Review the branch prepared reconcilement of related party accounts, match the closing balances to the general ledger and the cutoff statement, and ensure that departmental controls over entries to the proper accounts within the general ledger are being followed, then:
 - a. Determine the reasonableness of any unusual items noted in the reconciliation.
 - b. Determine if any old open items have been charged off and, if so, were the charge-offs appropriate and within head office policy.
 - Determine if any large or unusual items are outstanding, and review related correspondence.
 - d. Determine if any overdrafts exist in related party accounts, and determine how these overdrafts are monitored and approved by head office. Share this information with the examiner evaluating loans.
 - e. Retain custody of all trial balances, only if necessary and practical.
- For each account, determine the purpose (e.g., funding, lending, clearing, reserve allocation, etc.) and the level of volatility. Ensure that the purpose of the account is consistent with the balances and the volatility.

- Identify what interest, if any, is paid and received on due from/due to accounts to determine if the rates are above or below market rates. Share this information with the examiner evaluating earnings.
- 7. For accounts that represent reserves, determine the precise nature of these reserves, identifying all activity since the previous examination. Share this information with the examiner-in-charge and the examiners in charge of loan administration and earnings, if applicable.
- 8. Determine if any transfers of loans have occurred between examinations. If so, review the entries and share this information with the examiner in charge of loan review.
- Review the workpapers associated with the profit and loss accounts to ensure that reported earnings or losses are properly reflected in the due from/due to accounts with head office. Note whether provisions for general reserves are taken through earnings.
- 10. If the branch is in a net due from position, determine if it represents a concentration (greater than or equal to 25 percent) of the branch's net assets and assess the potential risks of such a concentration.
- Identify any office on which the branch relies heavily for funding and share this information with the examiner reviewing liquidity.
- 12. If the branch is operating under a supervisory agreement that limits net due from positions or imposes an asset maintenance requirement, test check for accuracy of reporting to the regulators.
- 13. Update the workpapers with any information that will facilitate future examinations.

Due From/Due To Related Offices Internal Control Questionnaire

Effective date July 1997

Section 3240.4

Review the branch's controls, policies, practices, and procedures for obtaining and servicing loans, placements, deposits, and borrowed funds from related parties. The branch's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

- Does the branch have in place a written policy approved by branch and head office management that:
 - a. Outlines the objectives of due from/due to related accounts?
 - b. Describes the branch's philosophy relative to funding and clearing needs, reserve policies, overdraft policies and approval limits, and proper recognition of profits and losses?
 - c. Provides a system of reporting requirements to monitor interoffice activity?
 - d. Provides for review and revision of established policy at least annually?
- 2. Does the branch maintain subsidiary records for each related office?
- Is the preparation, addition, and posting of the subsidiary related accounts records performed or adequately reviewed by persons who do not also:
 - a. Handle cash, telex, or wire transfers?
 - b. Issue official checks and drafts?
 - c. Prepare all supporting documents required for payment of debt?
- 4. Are subsidiary related account records reconciled with the general ledger accounts at an interval consistent with interoffice activity and are the reconciling items investigated by persons, who do not also:
 - a. Handle cash, telex, or wire transfers?
 - b. Prepare general ledger entries.
 - c. Prepare or post to the related party's borrowed funds records?
- 5. Are interest computations, if any, checked by persons who do not have access to cash?
- 6. Do monthly reports furnished to the head office reflect the activity of related accounts, including amounts outstanding, overdrafts, interest rates, interest paid to date, and anticipated future activity?
- 7. Is the foregoing information an adequate basis for evaluating internal control in that

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

In the event the branch is in a net due from position greater than or equal to 25 percent of net assets, conduct the following procedures.

- 9. Carefully review the FBO's strength-of-support assessment to determine whether any concerns exist with respect to its general ability to support its U.S. operations. If so, determine the extent to which the branch depends on head office or related parties for contingency funding, and any effect on the ability of the branch to meet third party obligations. Discuss any concerns with the examiner-in-charge for further guidance.
- 10. If the branch is in a net due from position greater than or equal to 25 percent of net assets with an affiliate located in a country other than its home country, determine:
 - a. If the affiliate is a financial institution that has been assigned a strength-ofsupport assessment or has received a rating by an independent agency.
 - b. If the affiliate is not a financial institution, discuss the nature and future of this funding relationship with branch management. Discuss any concerns with the examiner-in-charge.
- 11. Is the branch reconciling its accounts with related parties at an interval consistent with the interoffice activity, and is there a system to identify and monitor old items or large items?
- 12. Are extensions of credit being granted to or are loans being transferred to related parties? Are the credit extensions performing? At the time of transfer, were the assets performing?
- 13. Are the due from time deposits with related parties performing?
 - a. Are the placements continually renewed or is there actual payment at maturity?

- b. If the branch is providing funding to an offshore related financial institution, determine the purpose of the funding and its utilization.
 - Is the entity well capitalized?
 - · Are the funds used to lend to ICERC classified countries? Are these loans to finance trade transactions and are these loans performing?
 - Is the entity purchasing problem loans from the branch? If so, this relationship should be closely scrutinized because the branch may be funding the sale of its problem assets through the placement of funds with the purchasing entity.
- 14. Does the net due from related parties position represent a concentration of transfer risk to any one country that could have a significant impact on the repayment of the branch's third party liabilities?
- 15. If the branch is operating under an asset maintenance requirement, is it appropriately monitoring and accurately reporting due from/due to related office positions to the regulators in the asset maintenance computation?

Due From/Due To Related Offices Audit Guidelines

Effective date July 1997

Section 3240.5

- Using an appropriate sampling technique, select items for review of supporting documentation, including terms, balances, and other appropriate details, and request a positive confirmation from the related office. Control all answered confirmations and investigate any reported differences. Include all confirmations in the workpapers and document the disposition of all exceptions or no-replies.
- Examine supporting documents for accuracy and trace applicable entries, including proceeds, to detail records and to the general ledger.
- 3. Test check interest computations for accuracy and trace entries to appropriate accounts.
- 4. Examine transactions for consistency with the stated purpose of the related accounts.

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Contingent liabilities, also referred to as offbalance-sheet items, should be analyzed as part of the branch's overall risk management assessment. Potential exposure, funding sources, the adequacy of risk management, and internal controls for off-balance-sheet risks are specific matters that should be considered.

As a regular part of their operation, some branches are involved in originating financial contracts that may result in the acquisition of certain assets and liabilities at some future date, under certain conditions. Generally accepted accounting principles do not consider these contracts in themselves to be assets or liabilities and, thus, do not recognize them on the face of the balance sheet. These off-balance-sheet items are quite diverse in nature and purpose and may include such instruments as firm loan commitments, standby letters of credit, foreign exchange, financial futures, forward contracts, options, interest rate swap contracts, and other derivative products.

Greater competition, marketing innovations, and government deregulation have changed the focus of attention from contingent liabilities. In addition to assessing the risk in off-balancesheet instruments, examiners must also assess the risk of off-balance-sheet activities. Branches are now involved in a wide spectrum of banking activities designed to generate fee income, such as securities clearance and brokerage activities, data processing services, and investment and management advisory services. As the branches find more avenues of non-traditional banking activities available to them, they may expand the scope of services offered to customers. These new activities may involve risks which are difficult to quantify, such as legal risk, or reputational risk.

In recent years, there has been significant growth in the volume of contingent liabilities related to various derivative products. At the same time, growth in standby letters of credit enhancements has moderated due to global risk-based capital considerations.

There are many types of risks which the examiner should be aware of: principal (position), credit, and settlement risk (i.e., loss of principal due to default by a contractual party); interest rate (basis), market, and foreign exchange risk (i.e., depreciation of principal amount or loss of income due to rate, market or currency fluctuations); daylight overdraft risk (i.e., expo-

sure due to transactions originating and settling during the same day); liquidity risk (i.e., lack of funds to honor commitments leading to higher borrowing costs); country risk; and litigation risk. Of these, the major risk to consider would be credit risk, interest rate risk, and market risk.

It is essential that a system of controls be in place to limit off-balance-sheet risk. These controls, including policies, procedures, recordkeeping systems, and audit coverage, should be sufficiently detailed to ensure proper performance evaluation by branch and head office management, auditors, and regulatory authorities.

Formal written policies, stating goals and strategies and setting limitations at various levels, are necessary to prevent abuses and to act as benchmarks against which performance may be gauged. A limit should be placed on an activity's total volume. In addition, limits should be established for individual customers, and parameters set for traders. Procedures should be in place to ensure that operations are consistent with written policies. Comprehensive recordkeeping and reporting are needed for adequate audit coverage and management information. Most importantly, branch management should be aware of all off-balance-sheet activity and ensure that controls and procedures are in place to identify and monitor attendant risk.

The purpose of this section is to serve as a concise reminder of the major types of off-balance-sheet items. Examination objectives, examination procedures, and internal control questionnaires for these items are found in the appropriate sections of this manual, the Federal Reserve's Trading Activities Manual, and other similar material developed by the other federal and state bank supervisory agencies. For further guidance in this area, examiners should consult with their respective agencies.

Contingent liabilities containing primarily credit risk include the following categories:

COMMITMENTS TO MAKE OR PURCHASE LOANS OR TO EXTEND CREDIT IN THE FORM OF LEASE FINANCING ARRANGEMENTS

These transactions include the portion of commitments that obligate the branch to extend

credit in the form of loans (including credit card lines), participations in loans, lease financing receivables, or similar transactions. This category would include commitments for which the branch has charged a commitment fee or other consideration or otherwise has a legally binding

STANDBY LETTERS OF CREDIT

A standby letter of credit provides for payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the issuing bank's customer) upon the presentation of a draft or documentation required in the letter of credit. A standby letter of credit, typically, is unsecured and is payable against a simple statement of default or nonperformance. Refer to this manual's section on Letters of Credit for additional information.

COMMERCIAL AND SIMILAR LETTERS OF CREDIT

A commercial documentary letter of credit is an instrument in which a bank (issuing bank) undertakes to pay a party (beneficiary) named in the instrument a sum of money on behalf of the bank's customer (account party). This type of letter of credit is used most commonly to provide a bank's credit and possible financing to a commercial contract for the shipment of goods from seller to buyer. The beneficiary will be paid when the terms of the letter of credit are met and the required supporting documents are submitted to the paying or negotiating bank. Refer to this manual's section on Letters of Credit for additional information.

PARTICIPATIONS IN ACCEPTANCES CONVEYED TO OTHERS BY THE SUBJECT BRANCH

A banker's acceptance is a time draft or bill of exchange that has been drawn on and accepted by a banking institution for payment by that institution at some future date. Participations in acceptances conveyed to others by the accepting bank include such transactions that provide for

the other party to the participation to pay the amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults.

PARTICIPATIONS IN ACCEPTANCES ACQUIRED BY THE SUBJECT BRANCH

Participations in acceptances of other banks acquired by the branch (nonaccepting bank) include such transactions that provide for the nonaccepting bank to pay the amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults.

Contingent liabilities containing interest, market, and credit risk include the following categories:

FUTURES AND FORWARD CONTRACTS

Futures and forward contracts are tools for use in asset and liability management, and can be used by branches to effectively hedge portions of their portfolios against interest rate risk. Branches that engage in futures and forward contract activities should only do so in accordance with safe and sound banking practices, with levels of activity reasonably related to the branch's business needs and capacity to fulfill its obligations under the contracts. In managing their assets and liabilities, branches should evaluate the interest rate risk exposure resulting from their overall activities to ensure that the positions they take in futures and forward contract markets will reduce their risk exposure. Policy objectives should be formulated in light of the branch's entire asset and liability mix. Definitions of futures and forward contracts are as follows:

· Futures contracts are standardized contracts traded on organized exchanges to purchase or sell a specified security, money market instrument, or other financial undertaking on a future date at a specified price. Accordingly, the credit exposure is to the exchange and is generally considered to be negligible. However, this may not be the case for exchanges in less developed countries.

Forward contracts are over-the-counter contracts for forward placement or delayed delivery of securities in which one party agrees to purchase and another to sell a specified security at a specified price for future delivery. Contracts specifying settlement in excess of 30 days following trade date are considered to be forward contracts. Forward contracts are not traded on organized exchanges, generally have no required margin payments, and can only be terminated by agreement of both parties to the transaction.

STANDBY CONTRACTS AND OTHER OPTION ARRANGEMENTS

Standby contracts and other option arrangements are also tools for asset and liability management which, when properly used, can reduce the risks of interest rate fluctuations. Standby contracts are optional delivery forward contracts on U.S. government and agency securities, arranged between securities dealers and customers. The buyer of a standby contract (put option) acquires, upon paying a fee, the right to sell securities to the other party at a stated price at a future time. The seller of the standby (the issuer) receives the fee and must stand ready to

buy the securities at the other party's option. Exchange trading is conducted in options specifying delivery of debt securities, money market instruments, or futures contracts specifying delivery of debt securities.

FOREIGN EXCHANGE CONTRACTS

These are contracts to exchange one currency for another as of a specified date and time at a specified rate of exchange (price). Delivery of the currency may be spot (two or less business days) or forward (more than two business days).

INTEREST RATE SWAP CONTRACTS

Interest rate swap contacts are private, over-thecounter contracts between counterparties for exchanging interest payments for a specified period based on a notional principal amount. Entities generally enter into interest rate swaps for interest rate risk management; namely, to manage the interest rate exposures arising from asset and liability positions. Effective date July 1997

Branches do not have the authority to issue guarantees or sureties, except as may be incidental or usual in carrying on their banking business. Such an instance may occur when a branch has a substantial interest in the performance of the transaction involved or has a segregated deposit sufficient to cover its total potential liability.

A branch may also guarantee or endorse notes or other obligations sold by the branch for its own account. The amount of the obligations covered by such guarantee or endorsement is to be recorded as a contingent liability on the records of the branch. Furthermore, such liabilities are included in computing the aggregate indebtedness of the branch, which may be subject to limitations imposed by any applicable law or regulation.

A common example of a guarantee is a steamship letter of guarantee. Frequently, in an international sale of goods, the merchandise arrives at the importer's (buyer's) port and the complete negotiable bills of lading are either lost or delayed in transit. In such instances, it is

customary for the importer (buyer) to obtain immediate possession of the goods by providing the shipping company with a bank guarantee, often called a steamship guarantee, which relieves the shipping company of liability resulting from release of the goods without proper or complete negotiable title documents. Usually, the guarantee relies on a counter-guarantee issued to the branch by the importer.

All types of guarantees issued are to be recorded as contingent liabilities by the branch. Usually, the party for whom the guarantee was issued will reimburse the branch should it be required to pay under the guarantee; however, in certain situations, some other designated party may reimburse the branch. That other party may be designated in the guarantee agreement with the branch or in the guarantee instrument itself. The branch may also be reimbursed from segregated deposits held, pledged collateral, or by a counter-guarantor. Letters of credit, as distinguished from guarantees, are discussed in a separate section of this manual.

Guarantees Issued Examination Objectives

Effective date July 1997

Section 3310.2

- To determine if policies, practices, procedures, and internal controls regarding guarantees issued are adequate.
- 2. To determine if branch officers are operating in conformance with established guidelines.
- 3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
- 4. To determine the scope and adequacy of the audit function, as it applies to guarantees.
- To determine compliance with applicable laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Guarantees Issued Examination Procedures

Effective date July 1997

Section 3310.3

Refer to the Credit Risk Management, Examination Procedures section of this manual for examination procedures related to the risk assessment of guarantees.

- For guarantees issued in the selected review sample, check central liability file on borrower(s) indebted above the selected cutoff review line or borrower(s) displaying credit weakness or suspected of having additional liability in loan areas.
- 2. Determine compliance with any applicable laws and regulations pertaining to guarantees issued by performing the following steps:
 - Determine that the obligations covered by such guarantees or endorsements are shown as contingent liabilities on the

- records and in the reports of assets and liabilities of the branch and that such liabilities are included in computing the aggregate indebtedness of the branch.
- b. Determine which guarantees are subject to individual loan limitations to any one customer. Combine guarantees with any other extensions of credit to the account party by the issuing branch subject to loan limitations.
- Determine if the trial balance contains expired guarantees. If so, determine the branch's policies, practices, and procedures for disposing these guarantees.
- 4. Update the workpapers with any information that will facilitate future examinations.

Guarantees Issued Internal Control Questionnaire

Effective date July 1997

Section 3310.4

Review the branch's internal controls, policies, practices, and procedures for issuing and servicing guarantees.

- Has branch and head office management adopted written policies pertaining to guarantees issued that:
 - a. Establish procedures for reviewing guarantee applications?
 - b. Define qualified guarantee account parties?
 - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
- 2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

3. Are the subsidiary guarantees issued records balanced daily with the general ledger and are reconciling items adequately investigated by persons who do not normally handle guarantees?

- 4. Is a daily record maintained, summarizing guarantee transaction details, i.e., guarantees issued, guarantees canceled or renewed, payment made under guarantees, and fees collected, which support ledger entries?
- 5. Are blank guarantee forms safeguarded during banking hours and locked in the vault overnight?
- 6. Are all guarantees issued recorded as contingent liabilities and assigned consecutive numbers?
- 7. Are all guarantees issued recorded on individual customer (account party) liability ledgers?

CONCLUSION

- Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Effective date July 1997

Section 3310.5

- Test the addition of trial balances and their reconciliation to the general ledger.
- Using an appropriate sampling technique, select guarantees issued from the trial balance and:
 - a. Prepare and mail confirmation forms to account parties and beneficiaries. Guarantees serviced by other institutions, either whole guarantees or syndicate participations, should be confirmed only with the servicing institution (or lead bank). Guarantees serviced for other institutions, either whole guarantees or syndicate participations, should be confirmed with the buying institution and the account party. Confirmation forms should include account party's name, guarantee number, amount, fee charged, and a brief description of any collateral or counter-guarantee held.
 - b. After a reasonable time, mail second requests.
 - Follow up on any no-replies or exceptions and resolve differences.
 - d. Examine written guarantee instruments for completeness and terms, and verify amount to the trial balance.
 - e. Check to see that required initials of the approving officer are on the guarantee instrument.
 - f. Check to see that the signature on the guarantee is authorized.
 - g. Compare any collateral held with the description on the collateral register.
 - b. Determine that the proper assignments, hypothecation agreements, etc., are on file.

- Test the pricing of any negotiable collateral held.
- Determine that collateral margins are reasonable and in line with branch policy and legal requirements.
- k. List all collateral discrepancies and investigate.
- Determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.
- m. Forward a confirmation request on any collateral held outside the branch.
- Determine that each file contains documentation supporting counter-guarantees, if applicable.
- Review guarantee participation agreements for such items as fees charged the account party or remittance requirements and determine whether the account party has complied.
- p. If the branch paid a beneficiary under its guarantee, review disbursement ledgers and authorizations to determine whether payment was effected in accordance with the terms of the guarantee agreement and whether the branch was recompensed by the account party.
- 3. Review fees collected accounts by:
 - Reviewing and testing procedures for accounting for fees collected and for handling any adjustments.
 - Scanning fees collected for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

Effective date July 1997

Letters of credit are the most widely used instrument to finance international trade transactions. The two major types of letters of credit used are the commercial documentary letter of credit and the standby letter of credit.

COMMERCIAL DOCUMENTARY LETTERS OF CREDIT

This type of letter of credit is used most commonly to provide a bank's credit and possible financing to a commercial contract for the shipment of goods from seller to buyer. A commercial documentary letter of credit is a letter issued by a bank (issuing bank) on behalf of its customer (account party), a buyer of merchandise, to a seller (beneficiary), authorizing the seller to draw drafts up to a stipulated amount, under specified terms and undertaking to provide eventual payment for drafts drawn. The beneficiary will be paid when the terms of the letter of credit are met and the required supporting documents are submitted to the paying or negotiating bank.

The issuance and negotiation by banks of letters of credit are governed by Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits published by the International Chamber of Commerce. All letters of credit must be issued

- In favor of a definite beneficiary.
- For a specific amount of money.
- In a form clearly stating how payment to the beneficiary is to be made and under what conditions.
- With a definite expiration date.

Commercial letters of credit are issued in either irrevocable or revocable form. An irrevocable letter of credit cannot be changed without the agreement of all parties. Conversely, a revocable letter of credit can be canceled or amended by the issuing bank at any time, without notice to or the agreement of the beneficiary.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay, provided the beneficiary complies with the letter's terms and conditions. In contrast, the revocable credit is not truly a bank credit but serves as a device that provides the buyer and seller a

means of settling payments. Because a revocable credit can be canceled or changed without notice, the beneficiary should not rely on the credit, but rather on the willingness and ability of the buyer to meet the terms of the underlying contract.

The letter of credit may be sent to the beneficiary directly by the issuing bank or through the beneficiary's bank or through the issuing bank's correspondent located in the same place as the beneficiary. The correspondent may act as an "advising bank" that is, it may act as an agent of the issuing bank in forwarding the letter on to the beneficiary without any commitment to pay on its part. Advised letters of credit will bear a notation by the advising bank that it makes "no engagement" or words to that effect. An irrevocable advised letter of credit is, therefore, an undertaking to pay by the issuing bank but not by the advising bank.

Some beneficiaries (sellers), particularly those not familiar with the issuing bank, request that the buyer have the issuing bank ask the advising bank to add its "confirmation" to the issuing bank's irrevocable letter of credit. Confirmed letters of credit are evidenced by the confirming bank's notation: "We undertake that all drafts drawn . . . will be honored by us" or similar words. The beneficiary of a confirmed credit has a definite commitment to pay from a bank in his or her country and does not need to be concerned with the willingness or ability of the issuing bank to pay. One bank may play more than one role. For example, an advising bank may add its confirmation and be designated in the letter as the paying bank.

Payment terms of a letter of credit usually vary from sight to 180 days, although other terms sometimes are used. The letter will specify on which bank drafts are to be drawn. If the draft is drawn at sight, the bank will effect payment upon presentation of the draft provided the terms of the credit have been met. If the draft is a time draft, the drawee bank can accept the draft (by stamping "Accepted" on the face of the draft), which then can be held by either the seller or the seller's bank or the accepting bank until maturity. Alternatively, the accepted draft can be sold or discounted. (Refer to the Bankers' Acceptances section.)

Certain categories of commercial letters of credit, such as "back-to-back", "transferable", "deferred payment", "revolving", and "red

3320.1 Letters of Credit

clause" credits, contain specific elements of risk. Although these types of credits are infrequently seen, branches should exercise caution in their issuance and/or negotiation.

A back-to-back letter of credit is one where a commercial letter of credit (master credit) is used as security to support the issuance of a second credit to another supplier (seller). The beneficiary (seller) of the credit becomes the applicant of the second letter of credit. In other words, the beneficiary assumes the role of a middleman between the actual supplier and the ultimate buyer of the merchandise. The difference between the master credit amount and the back-to-back credit is the middleman's profit. Bank-to-back credits are most frequently seen in situations where the exporter (middleman) is unable to purchase merchandise on his own credit rating.

A transferable letter of credit enables the original beneficiary to transfer the rights of payment to one or more beneficiaries. These credits are normally seen when the original beneficiary acts as an agent and does not supply some or all of the merchandise or does not have the financial resources or credit necessary to purchase the merchandise. In some instances, the beneficiary may wish to keep the supplier and applicant ignorant of each other (so as to protect his profit as middleman) by requesting the advising bank to substitute his own name for that of the applicant. The rights in a transferable letter of credit may not be transferred by the second beneficiary to a third party unless otherwise stated.

Deferred payment letters of credit are similar to a commercial letter of credit in that they provide for payment at some date after shipment of the goods. However, this type of credit does not require a time draft to be presented for payment. The merchandise is released without payment. Instead, the issuing bank undertakes to reimburse the paying bank at some future date as stipulated in the credit. Deferred payment credits are discouraged by banks since no debt instrument exists to discount. The obligation represents a direct liability of the bank and is booked in a manner similar to the liability booked for an acceptance.

A revolving letter of credit allows for the amount of the credit to be renewed or automati-

cally reinstated without specific amendments to the credit. Such credits allow for flexibility in commercial dealings between exporters and importers; however, credits of this type usually specify a maximum overall amount which can be drawn for control purposes. Credits of this type can revolve in relation to time or value, and be cumulative or non-cumulative. In practice, the vast majority of letters of credit are non-revolving. Since the maximum exposure under an irrevocable revolving credit can be large, most revolving credits are issued in revocable form.

Originally the clause in the letter of credit was written in red ink to draw attention to the special nature of the credit. Hence, the name *Red Clause Credits*. The use of this clause permits the beneficiary to obtain an advance or preshipment advances from the advising or confirming bank. Its purpose is to provide the seller credit. Any advances are the responsibility of the issuing bank. Interest is normally charged by the bank making the advance until documents are presented and the bank is reimbursed by the issuing bank.

Documentation is of paramount importance in all letter of credit transactions. The branch is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Ultimate repayment often depends upon the eventual sale of the goods involved. Thus, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

STANDBY LETTERS OF CREDIT

A standby letter of credit provides for payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the issuing bank's customer) upon the presentation of a draft or the documentation, as required in the letter of credit. Although a standby letter of credit may arise from a commercial transaction, it usually is not linked directly to the shipment of goods from seller to buyer. It may cover performance of a construction contract, serve as an assurance to a bank that the seller will honor his or her obligations under warranties, or relate to the payment of a purely monetary obligation, for example, when

Letters of Credit 3320.1

the credit is used in backing payment of commercial paper.

Under all letters of credit, the banker expects the account party to be financially able to meet his or her commitments. A banker's payment under a commercial letter of credit for the customer's account is usually reimbursed immediately by the customer and does not become a loan. However, payment under a standby letter of credit generally occurs because the account party has defaulted on its primary obligation. That default can be a result of the customer being unable to pay or of a dispute between the beneficiary and the account party.

A standby letter of credit transaction involves greater potential risk for the issuing bank than does a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit retains nothing of value to protect against loss, whereas a commercial documentary letter of credit may provide the bank with title to the goods being shipped. To reduce the risk of a standby letter of credit, the issuing bank's credit analysis of the account party should be equivalent to that applicable to a borrower in an ordinary loan situation. For reporting purposes, standby letters of credit are shown as contingent liabilities in the branch's Report of Assets and Liabilities. Depending on any applicable state and federal laws and regulations, standby letters of credit may be subject to prudential limitations.

GOVERNMENT AND AGENCY GUARANTEED LETTERS OF CREDIT

The process of foreign trade also is facilitated by various U.S. government agencies and international organizations. Some programs guarantee payments under letters of credit issued by commercial banks under programs to promote U.S. exports or at the request of international organizations which reimburse banks for letters of credit issued on their behalf. The most common government agencies include the following:

The Export-Import Bank of the United States (Eximbank) is an independent agency of the U.S. government which facilitates the financing of U.S. exports through guarantying debt obligations acquired from U.S. exporters or through direct lending activities.

Private Export Funding Corporation (PEFCO) is a private corporation, incorporated in 1970, for the purpose of making U.S. dollar loans to foreign importers to finance purchases of goods or services of U.S. manufacture or origin. All loans made by PEFCO are unconditionally guaranteed by Eximbank.

Commodity Credit Corporation (CCC) is a U.S. government agency which provides commercial credit and political risk guarantees to facilitate the financing of U.S. commodity exports such as wheat and corn.

Agency for International Development (AID) is the largest unit of the International Development Co-operation Agency, administers most of the bilateral foreign aid programs of the U.S. government. AID provides U.S. dollars through loans and grants for foreign assistance recipients to purchase, principally from the U.S., products needed in connection with development programs and related technical and professional services.

International Bank for Reconstruction and Development (IBRD) is a transnational organization organized for the purpose of financing infrastructure and development projects in lesser developed countries.

Inter-American Development Bank (IADB), the oldest and largest regional multilateral development institution, was established in 1959 to help accelerate social and economic development projects in Latin America and the Caribbean.

Overseas Private Investment Corporation (OPIC) is a self-sustaining U.S. government corporation whose principal purpose is to promote economic growth in developing nations by encouraging U.S. private investment in those countries. OPIC promotes its objectives principally by insuring U.S. investors against political risks and financing selected investment projects through direct loans or loan guarantees.

ANTI-BOYCOTT REGULATIONS

The Export Administration Act of 1973 prohibits banks from taking or knowingly agreeing to take actions that support any boycott against a country friendly to the United States. Under

3320.1 Letters of Credit

anti-boycott regulations (which are issued by the Department of Commerce and enforced by the Office of Anti-Boycott Compliance), U.S. banks are required to report letters of credit they receive that include illegal boycott terms or conditions and should establish an ongoing program to review all letters of credit. These regulations apply to both domestic and overseas branches of all U.S. banks.

The anti-boycott provisions prohibit banks from opening, negotiating, confirming, or paying international letters of credit that contain illegal terms or conditions. The improper language is most often seen in documentary letters of credit, sight reimbursements, and pass-on letters of credit, but may also appear in drafts and wire payments. Often, a bank's customer

may try to add improper language orally rather than in writing. Boycott language includes clauses or requirements such as:

- Certification that the goods are not of a particular origin, such as Israeli or South African:
- Certification that any supplier or provider of services does not appear on the Arab blacklist;
- The condition, "Do not negotiate with blacklisted banks", or words to that effect:
- A request not to ship goods on a Israeli carrier or on a vessel or carrier that calls at Israel en route to a boycotting country; and
- A request for a certificate stating the origin or the goods or the destination of the goods.

Letters of Credit Examination Objectives

Effective date July 1997

Section 3320.2

- To determine if objectives, policies, practices, procedures, and internal controls regarding letters of credit are adequate.
- To determine whether branch officers are operating in conformance with established guidelines.
- 3. To determine the scope and adequacy of the audit function.
- To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
- To determine compliance with applicable laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Letters of Credit Examination Procedures

Effective date July 1997

Section 3320.3

- Analyze the following specific types of letters of credit (when applicable) to determine if:
 - a. For Red Clause Letters of Credit (Packing Credits):
 - Clean advance or anticipatory drawing finance to the beneficiary (exporter or agent) is authorized under the letter of credit.
 - The beneficiary undertakes to deliver within the expiration date the shipping documents called for in the letter of credit.
 - The foreign bank makes advances to the beneficiary and is paid by drawing its own draft on the opening bank or the beneficiary is authorized to draw its draft on the issuing bank and the drafts received charged to the importer.
 - b. For Back-to-Back Letters of Credit:
 - The backing letter of credit is properly assigned as collateral to the bank issuing the letter of credit.
 - The terms of the letter of credit issued are identical to the backing credit except that:
 - The beneficiary and account party are different.
 - The amount may be less but not more than the backing credit.
 - The expiration date is reduced by sufficient time to allow completion of the transaction before the backing letter of credit expires.
 - The beneficiary of the backing letter of credit is a regular customer of the branch opening the second letter of credit.
 - c. For Standby Letters of Credit:
 - They represent undertakings to pay up to a specific amount upon presentation of a draft(s) and/or documents before a specified date.
 - They represent obligations to a beneficiary on part of the issuer to:
 - Repay money borrowed by or advanced to or for the account party.
 - Make payment on account of any indebtedness undertaken by the account party. Make payment on account of default by the account party in the performance of an obli-

- gation, e.g., default on loans, performance of contracts, or relating to maritime liens.
- d. For Deferred Payment Letters of Credit (trade-related):
 - The letter of credit calls for drawing of sight drafts with the provision that such drafts are not to be paid until a specified period after presentation and surrender of shipping documents to the branch.
 - The branch's liability for outstanding letters of credit calling for deferred payment is reflected as contingent liability until such documents presented under the letter of credit are honored.
 - The branch has received, approved, and acknowledged receipt of the documents thereby becoming directly liable to pay the beneficiary at a determinable future date(s).
 - Payment will be made to the beneficiary in a specified number of months or quarterly, semiannually, annually, or beyond. (If the branch has advanced money to the beneficiary against the deferred payment letter of credit, with its proceeds assigned as collateral to repay the advance, the transaction should be treated as a loan rather than a deferred payment letter of credit).
- e. For Clean Deferred Payment Letters of Credit:
 - Such deferred payment credits call for future payment against simple receipt without documents evidencing an underlying trade transaction.
 - Such letters of credit are shown as direct liabilities on the branch's records when drafts are presented by the beneficiary and received by the branch.
- f. For Authority To Purchase:
 - The authority to purchase is with recourse to the drawer, without recourse to the drawer, or without recourse to the drawer but confirmed by the negotiating bank.
- g. For Agency for International Development (AID) Letters of Credit:
 - The branch or foreign banking organization (FBO) has an AID letter of commitment authorizing the transaction.

- The branch has checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the AID commitment.
- A letter of agreement between the branch or FBO and the foreign government exists whereby the branch or FBO has recourse should AID fail to reimburse the branch or FBO.
- h. For Commodity Credit Corporation (CCC) Letters of Credit:
 - The branch or FBO has a CCC letter of commitment authorizing the branch or FBO under examination to issue letters of credit to beneficiaries supplying eligible commodities to foreign importers.
 - In instances where the branch has issued standby letters of credit in favor of the CCC, the following requirement has been met:
 - At least 10 percent of the financed amount is confirmed, i.e., guaranteed by a U.S. bank for commercial credit risk. The total value of the credit is advised through a U.S. bank.
- i. For the Export-Import Bank of the United States:
 - The branch or FBO has an agency agreement from Eximbank stating:
 - Eximbank has entered into a line of credit with a foreign borrower.
 - The amount of the line.
 - The branch or FBO has been designated to issue the letter of credit(s).
 - Any payments made under an Eximbank approved letter of credit will be reimbursed by Eximbank.
 - The branch has checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the Eximbank agreement.
- j. For Advised (Notified) Letters of Credit:
 - The branch is only advising the beneficiary without responsibility on its part.

- (A spot check should be made of these credits to ensure that the branch has not committed to an engagement under the letters of credit.)
- k. For Other Types of Letters of Credit:
 - Any of the following U.S. government agencies and international organizations reimburse the branch for issuing letters of credit on their behalf:
 - International Bank for Reconstruction and Development (IBRD).
 - Inter-American Development Bank (IADB).
 - Overseas Private Investment Corporation (OPIC).
- Determine that the amount of standby letters of credit does not exceed the prudential limitations on loans imposed by any applicable state and federal law (including limitations to any one customer or on aggregate extensions of credit).
 - a. Combine standby letters of credit with any other nonaccepted loans to the account party by the issuing branch for the purpose of applying any state and federal loan limitations to any one customer.
 - b. A standby letter of credit is not subject to loan limitations imposed by applicable law in the following instances:
 - Prior to or at the time of issuance of the credit, the issuing branch is paid an amount equal to the branch's maximum liability under the standby letter of credit.
 - Prior to or at the time of issuance, the branch has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the branch's maximum liability under the standby letter of credit.
- 3. Determine that the credit standing of the account party under any standby letter of credit is the subject of credit analysis equivalent to that applicable to a potential borrower in an ordinary loan situation.

Letters of Credit Internal Control Questionnaire

Effective date July 1997

Section 3320.4

POLICIES

- Has branch and head office management adopted written letter of credit policies that:
 - a. Establish procedures for reviewing letter of credit applications?
 - b. Define qualified customers?
 - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
 - d. Establish procedures to ensure that letters of credit are issued and confirmed under approved credit lines?
- 2. Are letter of credit policies reviewed at least annually to determine if they are compatible with changing market conditions?

employees who do not process or record letter of credit transactions?

COMMISSIONS

- 10. Is the preparation and posting of commissions (fees) performed or reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
- Are any independent commission computations made and compared or adequately tested to initial commission records by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?

RECORDS

- 3. Is the preparation and posting of subsidiary letter of credit records performed or reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
- 4. Are the subsidiary letter of credit records (control totals) balanced daily with the appropriate general ledger accounts, and are reconciling items adequately investigated by persons who do not normally handle letters of credit and post records?
- 5. Are delinquencies arising from the nonpayment of instruments relating to letters of credit prepared for and reviewed by management on a timely basis?
- 6. Are inquiries regarding letter of credit balances received and investigated by persons who do not normally process documents, handle settlements, or post records?
- 7. Are bookkeeping adjustments checked and approved by an appropriate officer?
- 8. Is a daily record maintained that summarizes letter of credit transaction details, i.e., letters of credit issued, payments received, and commissions and fees collected, to support applicable general ledger account entries?
- Are letter of credit record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by

DOCUMENTATION

- 12. Are the terms, dates, weights, description of merchandise, etc. shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences with those detailed in the letters of credit instruments? Has the branch developed procedures, such as a document checklist, to ensure that all documents required by the letter of credit are presented?
- 13. Are procedures in effect to determine if:
 - a. The above documents are signed when required?
 - b. All discrepancies have been resolved with the agreement of all parties.
 - c. All copies of letters of credit are initialed by the officer who signed the original letter of credit?
 - d. All amendments to letters of credit are approved by an officer?

DEFERRED PAYMENT LETTERS OF CREDIT

- 14. Are deferred payment letters of credit:
 - a. Recorded as direct assets and liabilities of the branch after it approves and agrees to honor the beneficiaries' documents for payment?

b. Included in "other assets" and "other liabilities" in the call report?

STANDBY LETTERS OF CREDIT

15. Are standby letters of credit segregated or readily identifiable from other types of letters of credit and/or guarantees?

OTHER

- 16. Are outstanding letter of credit record copies and unissued forms safeguarded during banking hours and secured in the vault overnight?
- 17. Are advised letters of credit recorded as memoranda accounts, separate from letters of credit issued or confirmed by the branch?
- 18. Are letters of credit that have been issued with reliance upon a bank, whether on behalf of, at the request of, or under an agency agreement with the bank, recorded as contingent liabilities under the name of that bank?
- 19. Are any commission rebates approved by an officer?
- 20. Does the branch have an internal review system that:
 - a. Reexamines collateral items for negotiability and proper assignment?
 - b. Test check values assigned to collateral when the letter of credit is issued or

- confirmed and at frequent intervals there-
- c. Determines that customer payments of letters of credit issued are promptly posted?
- d. Determines all delinquencies arising from the nonpayment of instruments relating to letters of credit?
- e. Ensures expired letters of credit are closed according to branch policy generally 15 to 30 days after expiration.
- 21. Are all letters of credit recorded and assigned consecutive numbers?
- 22. Are lending officers frequently informed of maturing letters of credit and letter of credit
- 23. Is documentation stored in a fireproof vault?
- 24. Are procedures in place for positive identification of the beneficiary prior to release of funds to ensure that the true beneficiary receives the funds?

CONCLUSION

- 26. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 27. Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Letters of Credit Audit Guidelines

Effective date July 1997

Section 3320.5

- Test the addition of the trial balances and the reconciliation of the trial balances to the general ledger.
- Review the commission accounts relating to issuing, amending, confirming, and negotiating letters of credit by:
 - Reviewing and testing procedures for accounting for commissions and the handling of adjustments.
- Scanning commissions for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.
- Review all unpaid letters of credit and ascertain that management has sound policies and procedures for resolving disputes.

Effective date July 1997

Trading activities include the purchase or sale of a wide range of financial instruments for speculative or hedging purposes. The range of trading instruments has experienced substantial growth in recent years. The most common instruments seen at branches include derivative products, foreign exchange, and securities. To conduct a thorough review of a trading operation, the Federal Reserve Trading Activities Manual ("TAM") should be used as a primary reference. However, the TAM is very detailed, and is applicable primarily to the most active and complex trading operations. The TAM is divided into two sections. The first section of the TAM discusses different types of trading risk plus specific detail on examination objectives, procedures, and internal control questionnaires for the core areas of any trading operation. The second section describes financial instruments that are essential to the examiner's understanding and successful implementation of a trading activities examination. These guidelines should be tailored by the examiner based on the size and sophistication of the branch and information from recent audits and examinations with input from the examiner-in-charge.

The objective of examining the trading function is to ensure that management has adequate systems to identify and measure the risks of the activities, and has taken appropriate measures to manage the risk. The systems established by management should be commensurate with the risks taken. Additionally, it is important to determine whether risk exposures are excessive relative to the branch's risk profile.

The following information is intended to provide general guidelines for reviewing a small, noncomplex trading operation, where only a few types of instruments are being traded. The general approach is to evaluate the office's policies, procedures, limits, and the content and accuracy of management information reports. In addition, operational controls are reviewed to ensure that adequate segregation of duties exist between the traders and the back office.

POLICIES, PROCEDURES AND LIMITS

Management's objective(s) for the trading function and the method used to establish strategies should be clear. The objective(s) will usually fit into one or more of the following categories: speculation, hedging, providing a service to customers, or facilitating other business transactions.

Trading policies should be reviewed and should contain, at a minimum, the following:

- A list of approved trading products and approved brokers;
- Authorization for every trader to conduct trades;
- Reporting lines for trading and back office staff;
- Guidelines for the frequency of preparing management reports;
- Guidelines for calculating open positions;
- Procedures for estimating the risk inherent in open positions;
- Position limits and stop-loss limits for each product and each trader; and,
- Procedures for obtaining approval to trade a new product.

If traders have exceeded the limits established in the policies, determine whether traders and management took appropriate action, and whether details of the instance(s)were documented and communicated to senior management.

Traders' prior experience and the level of ongoing training should be reviewed for adequacy. The traders' journals should be reviewed to determine whether profit and loss and open positions agree with official internal records, activities conducted are consistent with the strategy and objectives stated by management, transactions are accurately reported, and unauthorized transactions are being conducted.

MANAGEMENT INFORMATION REPORTS

Management reports should contain sufficient information to provide management with an adequate level of understanding of the branch's trading activities. Reports should detail trader positions, daily revaluation of open positions, interest sensitive gaps, and profit and loss. The accuracy of management reports should be tested using subsidiary records to recalculate figures. Reported figures for open positions should also

3330.1 Trading Activities

be compared to limits established in the policies. Generally, reports for open positions and interest sensitivity should be prepared daily, and those for profit and loss and revaluations should be prepared at least weekly. At a minimum, the frequency of reports should be consistent with limits. For example, if the policy establishes an intra-day open position limit, the profit and loss should be calculated several times during the day.

OPERATIONAL CONTROLS

Examiners must evaluate the effectiveness of established operational controls within the trading function. These controls should cover segregation of duties, systems for reconciling trading positions, profits and losses, and value at risk; and should establish a system for settling trade transactions. In addition, internal audits of the office's trading activities should be conducted regularly.

Segregation of duties will ensure that instances of fraud or embezzlement, or violations of regulations are minimized. There is a clear need to separate trading personnel from control of receipts, disbursements and custody functions. Persons executing transactions should not confirm, reconcile, revalue, or clear transactions or control the disbursement of funds, securities or other payments. Persons initiating transactions should not confirm trades, revalue positions, approve or make general ledger entries, or resolve disputed trades.

Reconciliations should be performed on a timely basis. Persons performing reconciliations should be independent of the person responsible for the input of transaction data. In addition, segregation must occur between persons reconciling and persons confirming transactions. Any discrepancies should be brought immediately to

the attention of the appropriate operations manager.

Examiners should review the various methods of settlement or the range of products traded, and any exceptions to commonly accepted practices should be noted. Unsettled items should be monitored closely by the branch. Settlement risk should be controlled through the continuous monitoring of movement of the branch's money and securities and by the establishment of counterparty limits.

Internal audits of the branch's trading activities should be conducted regularly. The frequency of internal audits will depend upon the complexity and level of activity of the branch's trading operations. The scope of the audits should include a review of trading risk management. Procedures for following up on audit exceptions should be adequate. The examiner should review the internal audit reports to determine the severity of deficiencies identified, and should determine whether management implemented corrective action in a timely manner.

Generally, the head trader has regular meetings with senior management. If minutes of these meetings are maintained, the minutes should be reviewed to determine the following:

- management was adequately informed of the risks taken;
- circumstances when traders exceeded limits were reported to management;
- management was informed when market conditions were unfavorable to existing positions;
- any improper activities or defalcation were disclosed; and information in the minutes is accurate.

If minutes are not maintained, or meetings are not held, the examiner should recommend the branch do so if the amount of activity warrants such a practice. Effective date July 1997

Traditional ratio and peer earnings analyses are not relevant at a branch because earnings are largely influenced by the role of the branch within the foreign banking organization (FBO).

Some FBOs maintain a U.S. presence to meet certain global portfolio considerations. As a result, their U.S. operations may likely engage in a wide range of activities similar to those of U.S. domestic banks. Other FBOs may have different objectives in establishing a U.S. presence, such as to provide funding and clearing services. A branch may also benefit from unique relationships that have a positive effect on its earnings, such as interest free funds, advances from the head office or managing assets not reflected on its books. Therefore, earnings should be evaluated primarily against budgeted numbers, which should be based on the branch's strategic plan. The examiner should also determine the role that the earnings and revenue structure plays in the context of the overall U.S. operations and objectives of the FBO. Comments may be warranted as to the adequacy of such results.

In establishing the budget, management should assess the broad range of financial and operational risk exposures, which are encompassed in the strategic plan. Projections should take into account not only the composition, quality, and risk structure of branch assets but also the internal control environment under which the assets are booked. Further, management's ability to prepare realistic budgets and meet budgeted projections would indicate some measure of effective planning and control over the branch's activities. To maximize effectiveness, budget projections should be periodically reviewed and updated as conditions change throughout the fiscal year. Actual results should be periodically compared to budget and material variances identified and reviewed management.

GENERAL EXAMINATION APPROACH

Earnings are not a rated component of the branch rating system, although the level of earnings or absence of earnings may affect rating components. The review of earnings also provides important information on the nature and efficiency of the branch's operations. The evaluation of earnings will consider, primarily, the effectiveness of a branch's comprehensive risk management procedures as it affects budgetary performance. Accordingly, variances to budgets should be reviewed. Persistent variances or exceptions may indicate poor planning or unrealistic projections, barring changes in economic and market conditions and other external factors or influences from the head office, which are beyond the branch's control.

The accuracy and integrity of earnings presented in risk management reports should be evaluated. For instance, reported earnings that do not properly reflect potential losses in the branch's credit risk exposures or accrued income on nonperforming loans may raise questions about the effectiveness of financial and accounting controls. The examiner should keep in mind, however, that the consolidated benefits derived by the FBO, as a result of maintaining a market presence to facilitate a global banking service network, may offset any earnings deficiencies or continued loss operations. Accordingly, the branch's strategic plan and function within the FBO and standards used by the head office to evaluate earnings performance must be ascertained and analyzed.

Examining the changes in earnings over time (a trend analysis) is a fundamental method for evaluating earnings. The trend in overall earnings and trends in earnings components should be reviewed to the extent that the branch's strategic plan has not changed significantly. Any significant changes or variances in profits or any of the components of income and expense should be investigated. Improving, deteriorating, and even flat earnings can be the result of not only changes in economic conditions but also of management's actions or influence over earnings through intrabank transactions. Some profitability ratios have been used, including net interest income/average assets (net interest margin) and net operating income/average assets, to make such an assessment. While providing a basis for analysis, particularly in year-toyear comparisons, earnings ratios can vary significantly among branches, depending on the nature of branch activity and the degree of support or influence exerted by head office.

PROFIT CENTERS AND COST CENTERS

Generally, branches will function as profit centers or cost centers. As an independent profit center, a branch will likely have a broad earning asset base and could have substantial off-balance-sheet activities. The branch would likely offer a broad array of products and services. Thus, earning assets and fee-based services would be primary sources of income. Examiners should consider the income distribution and the relative profitability and stability of the various sources of income.

As a cost center, the branch would serve a more narrowly defined central purpose of either providing a service to the head office or the FBO's customer network, such as a provider of funds to other bank offices. As such, the branch would likely offer only a limited number of products or services. Earnings at such offices will generally be less than robust.

Accordingly, profitability as a factor in evaluating the branch is diminished. In these instances traditional ratio and trend analysis is not relevant and alternate analysis techniques should be employed. The examiner should determine the standards that head office management uses in evaluating the branch's performance. This analysis will focus on the branch's strategic plan or primary function, for example, to serve as a source of liquidity for the head office or other branches, to service the FBO's trade-related business or to give the FBO a presence in a particular geographic location as part of its global banking network.

FACTORS AFFECTING EARNINGS

The Mission of the Office

The level of earnings would generally be driven by the branch's mission. In this context, internal factors could significantly influence earnings to the extent that a branch's earnings are essentially managed by the head office. To make this determination, examiners should carefully evaluate reported income for unusually high or low profit margins. For example, a branch may have ancillary functions from which it incurs additional expense or receives supplementary income, such as managing an offshore book or providing management or technical services to other offices

in a regional office function. If the fees for these services are not directly related to or based on the fair value of goods and services received, the branch's earnings can be affected. Services could include electronic data processing, audit and credit review, credit management, and foreign exchange and correspondent banking services.

Funding Sources

A branch that is funded through borrowings from related entities may have its cost of funds adjusted above or below market rates or even priced below the FBO's cost of funds. The head office might also provide an interest free capital allocation, or fund the branch's reserves at no cost. In these ways, the head office can either subsidize or reduce the branch's net interest income.

Transfer of Assets

The FBO may also transfer assets to or from a branch's books, which also will affect earnings. The transfer of nonperforming and other problem loans from the branch to the head office or another branch of the FBO will improve a branch's earnings and, conversely, negatively affect the earnings of any branch designated by the FBO as a workout branch. Low quality loans maintained on a branch's books would reduce interest income to the extent that full interest payments are not received. The transfer of such assets from the books of a branch would improve the quality of its assets, support its net interest income, and reduce its need for loan loss provisions and charge-offs. High quality earning assets may also be transferred to a branch's books from the head office. This may occur with start-up offices or branches that cannot otherwise generate earning assets at a level to sustain operations and fund the cost of doing business.

Accounting Considerations

Earnings at a branch may also be distorted to some extent because of the effect of home country accounting standards, administrative, tax, or other external influences. Accordingly, in reviewing earnings, the examiner should adjust branch income and expense statements to correspond with U.S. generally accepted accounting principles. If statements cannot be adjusted, the examiner's written analysis must take into consideration major accounting aberrations. More commonly seen accounting exceptions may include:

- Recognizing interest income on loans, which, according to U.S. standards, should be placed on nonaccrual status.
- All U.S. offices of a foreign bank may be combined for income tax purposes; accordingly, taxes might be calculated by a regional office and the branch may not accrue for taxes.
- Failure to record unrecognized gains and losses on trading assets and certain off-balance sheet contracts in accordance with FASB 115 and FIN 39 can affect both asset valuations and earnings.

ANALYTICAL REVIEW

Interest Income

Recognizing that branch earnings are primarily evaluated against budgeted numbers, a comparison of detailed balances on a period-to-period basis also should be performed to assess trends in account balances. Such a review also would provide the examiner with an understanding of branch operations and help to identify potential problem situations. The analysis of net interest income will give an indication of management's ability to borrow at attractive rates and invest those funds with maximum profitable results. The level and trend of net interest income should be established and evaluated. As with any financial institution, the composition of net interest income should be reviewed for quality and stability.

In analyzing net interest income, the computation of net interest margin (interest income minus interest expense, divided by average earnings assets) is helpful, although the potential distortion of net interest income through interoffice transactions can limit the usefulness of the ratio. When discussing growth in earnings, the examiner should clearly differentiate between increases due to rates or yields versus volumes of earning assets. An improvement in net interest income, as a percentage of earning assets, may reflect favorably on management's ability to invest its funds at favorable yields or its ability to find less expensive sources of funds. However, it also may reflect changes in rates on

interoffice transactions. The management of interest rate risk also can affect earnings. An aggressive or speculative funding policy, whereby the branch is permitted to maintain large interest rate sensitivity gaps, could result in material increases or decreases in margins.

Asset Yields

An analysis of asset yields should provide a measure of the branch's ability to invest funds in earning assets that provide a rate of return over the cost of funds. The analysis of asset yields and cost of funds should include whether market rates are paid for funds borrowed from the interbank markets and the level and cost of interoffice funding activities. If market rates of interest are not charged on interoffice borrowings or paid on interoffice placements, net interest income can be materially distorted. For example, if a branch is a net user of head office or interoffice funds, rates on intrabank borrowings could be adjusted upward or downward to increase or reduce the branch's cost of funds, which would flow through to net interest income. A branch that is a net provider of funds to the bank may be required to charge below market rates to other offices of the FBO. This situation would have an adverse affect on gross interest income and apply downward pressure to the net interest margin.

The level of nonperforming assets would also adversely affect net interest income. Nonperforming and renegotiated credits either provide no income or provide a reduced rate of income to the extent that the assets are no longer profitable relative to the cost of funds and the cost of doing business.

Reserves

Regulatory agencies have long recognized that an allowance for loan loss reserves is only meaningful for the bank as a whole and not on a branch by branch basis. Accordingly, branches of FBOs are not required to establish separate loan loss reserves on the books of each branch, but may do so voluntarily, or to meet local requirements. Provisions for loan loss reserves may either be transferred to the branch from the head or regional office, or may be directly charged against the branch's earnings. However, unlike at stand-alone operations that are sepa-

rately capitalized, concerns arising from inadequate loan loss reserves are not key issues at a branch.

Other Income and Expenses

Examiners should analyze the composition, level, and trend of other income and expenses. Noninterest income would include trading commissions and fees, deposit service charges, and letter of credit fees, among other items. Noninterest expense includes personnel and occupancy expense, and other operating expenses that arise from the normal activities of the branch. An analysis of these components would be especially valuable when evaluating a limited purpose branch or a branch that is suffering operating losses. Fees for intrabank services provided or received from related entities should also be reviewed. Earnings can be materially distorted if market rates are not charged for these services.

Extraordinary Gains or Losses

Extraordinary gains or losses result from anything outside the normal operations of a branch and should be analyzed carefully for their effect on earnings. Generally, extraordinary gains or losses result from the sale or disposal of assets and because of accounting changes. Examiners

should note that "extraordinary" as used in the context of the examination report is not the same as defined in U.S. generally accepted accounting principles.

Offshore Shell Branches

Earnings for offshore shell branches should be maintained separately from those of the U.S. branch. As such, report comments should be limited to the income and expenses of the U.S. branch. Earnings for the offshore branch are frequently commingled in the U.S. branch's management reports. The U.S. branch may absorb the offshore shell branch's indirect expenses, such as personnel expenses, without charging a fee. The significance of these indirect expenses varies depending upon the relationship of the U.S. branch to the offshore shell branch. However, because the allocation of these expenses are ultimately under the direction of head office management, exception should not be taken to this practice. Also, examiners, generally should not question the tax implication to the U.S. branch if the branch and the offshore shell branch file a combined federal income tax return. However, expenses between a branch and a related U.S. banking subsidiary of the foreign banking organization should be properly allocated and in accordance with applicable laws and regulations.

Income and Expense Examination Objectives

Effective date July 1997

Section 3400.2

- To review and understand the branch's strategic plan and mission within the FBO, specifically the earnings objectives.
- To assess management's ability to prepare realistic earnings projections and the effectiveness of the overall budgeting program for monitoring and controlling income and expense.
- To evaluate the reasonableness of performance targets given the branch's strategic plan and mission objectives, particularly with respect to budget variances.
- 4. To determine whether budgets are reasonable.
- To determine to what extent earnings are affected by such factors as above or below market interoffice funding, interoffice transfers, and interoffice expense allocations.
- 6. To analyze the level of significant trends in income and expense, particularly in terms

- of the branch's strategic plan, and current economic conditions.
- 7. To determine and comment on whether income reported to the head office, under the FBO's accounting procedures, accurately reflect true earnings, when adjusted for head office subsidies and the charges related to likely future loan losses.
- To evaluate the adequacy of financial and accounting controls relating to income and expense.
- 9. To evaluate the effect on earnings of any unusual and extraordinary gains or losses.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient.

Income And Expense

Examination Procedures Effective date July 1997

Section 3400.3

- Determine to what degree the branch is a profit center. If it is a profit center, calculate the net interest margin and review the trend. Consider the following:
 - a. To what degree does the agency raise its own funds and set its own cost of funds?
 - b. How is the pricing of loans and funds determined? Is it market driven or controlled by other factors?
 - c. Are transfer costs to affiliates reasonable, in relation to the services provided?
 - d. To what extent do transfer costs/benefits affect net earnings?
- 2. Determine if any significant changes have occurred in:
 - a. The branch's operations.
 - b. Accounting practices in U.S. or home country.
 - c. The branch's financial reporting.
 - d. General business conditions in U.S. or home country.
 - e. Tax codes in the U.S. or home country.
- 3. Obtain current financial statements, internal operating reports, interim financial statements, reports filed with the Federal Reserve, daily statements of assets and liabilities, and other available financial information. Look for the development or continuation of adverse trends and other significant or unusual trends or fluctuations. Primary considerations should include whether:
 - Significant structural changes are occurring in the branch that may affect the earnings stream.
 - b. The branch is making use of tax carry-backs or carryforwards.
 - c. Earnings are static or declining, as a percentage of total resources.
 - d. Income before securities gains and losses, is decreasing as a percentage of total revenues.
 - e. The ratio of operating expense to operating revenue is increasing.
 - f. Income and expense trends are inconsistent.
 - g. The spread between interest earned and interest paid is decreasing.
 - h. Loan losses are increasing.
 - Provisions for loan losses, if applicable, are sufficient to cover loan losses and whether overall reserves at an adequate level.

- There is evidence that sources of interest and other revenues have changed since the prior examination.
- k. There are any differences between branch accounting practices and U.S. regulatory accounting standards and generally accepted U.S. accounting principles.
- 4. Obtain and review planning procedures, profit plans, budgets, mid-and long-range financial plans, economic advisory reports, and any related progress reports and:
 - a. Compare actual results to budgeted amounts.
 - b. Determine the impact of specific goals that have been set.
 - c. Determine the frequency of planning revisions.
 - d. Determine how planning revisions are triggered.
 - e. Determine who initiates plan revisions.
 - f. Determine whether explanations are required for significant variations and whether causes are ascertained to implement corrective action.
 - g. Determine the sources of input for forecasts, plans, and budgets.
- 5. Review ledger accounts for unusual entries. Examples of such items include:
 - a. Significant deviations from the normal amounts of recurring entries.
 - Unusual debit entries in income accounts or unusual credit entries in expense accounts.
 - c. Significant entries from an unusual source, such as a journal entry.
 - d. Significant entries in other income or other expense, which may indicate fees or service losses on an off-balance-sheet activity (i.e., financial advisory or underwriting services).
- Investigate conditions of interest disclosed by the procedures in the preceding steps by:
 - a. Discussing exceptions or questionable findings with the examiner responsible for conducting those aspects of the examination that are most closely related to the item of interest to determine if a satisfactory explanation already has been obtained.

- b. Reviewing copies of workpapers prepared by internal auditors or management that explain account fluctuations from prior periods or from budgeted amounts.
- c. Discussing unresolved items with management.
- d. Reviewing underlying supporting data and records, as necessary, to substantiate explanations advanced by management.
- e. Performing any other procedures considered necessary to substantiate the authenticity of the explanations given.
- f. Reaching a conclusion as to the reasonableness of any explanations offered by

- other examiners or management, and deciding whether extensions of examination or verification procedures are necessary.
- 7. Review with officers and prepare, in appropriate report format, listings of deficiencies in and deviations from policies, practices, procedures, internal controls, and adverse
- 8. Prepare a complete set of workpapers to support examiner conclusions and discuss all material findings with management.

Effective date July 1997

Management information systems (MIS) should gather, interpret, and communicate information regarding the branch's business activities and their inherent risks. Accurate, informative, and timely MIS are essential to the prudent operation of any branch office. In fact, the examiner's assessment of the quality of the MIS is an important factor in the overall evaluation of the risk management process, which is discussed in the ROCA Rating System section of this manual.

In the evaluation of MIS, examiners should determine the extent to which the risk management function monitors and reports the branch's risk exposures to local and head office management.¹ Risk exposure levels and other significant measures such as profit and loss statements should be reported to managers who supervise but do not, themselves, have operational responsibilities in the area of activity. Frequent reports should be made as warranted by the activity and type of risk. Reports to head office management may occur less frequently, but examiners should determine whether the frequency of reporting is sufficient for head office to maintain proper oversight over the branch's activities.

The form and content of the MIS will relate to the branch's operations and organization, policies and procedures, and management reporting lines. Examiners will find that the form of branch management information systems will vary substantially with no particular structure shown to be optimum. MIS, however, generally take two forms: computing systems with business applications and management reporting. For branches with extensive lending or trading operations, a computerized system should be in place. For branches with more limited operations in terms of risk and size, an elaborate computerized system may not be cost effective.

Not all management information systems are fully integrated within the branch or within the FBO. Generally, this aspect should be evaluated based on the complexity and degree of risk in the branch's activities.

Examiners should expect to see varying degrees of manual intervention and should determine whether the integrity of the data is preserved through proper controls, which will factor into the overall assessment of the branch's

operational controls. The examiner should review and evaluate the sophistication and capability of the branch's computer systems and software, which should be capable of supporting, processing, and monitoring the branch's changing risk profile. Generally, in evaluating the individual branch management information system, the examiner should focus on its overall effectiveness in monitoring the branch's level of risk within established parameters rather than its form

Other considerations in evaluating the MIS include:

- Whether reports are presented in a format that is easily read and understood by senior management;
- Whether the branch has personnel with sufficient expertise to maintain MIS;
- Whether reports are updated and customized to reflect changes in the business environment or management's requirements;
- Whether an adequate reconcilement procedure is in place to ensure the integrity of data inputs; and
- Whether the system is independently audited by internal and external personnel with sufficient expertise to perform a comprehensive review of management reporting, financial applications, and systems capacity.

Management reporting summarizes the branch's day-to-day operations, including risk exposure. Reports also serve to provide management with an overall view of business activity for strategic planning. Reporting may be conducted via telephone, computer, correspondence, meetings, periodic management reports, audits, and examination reports. Examiners should evaluate the reporting process to determine whether it is sufficiently comprehensive for sound decision-making both on a day-to-day level and for future planning. To the extent that problems in specific areas of the branch may relate to inaccurate or inadequate reporting, the examiner also should review results and comments from other areas of the examination.

If the branch has extensive reporting requirements, it is not necessary to review each report. Instead the examiner should summarize the monitoring process in each area, giving only such information as is needed to justify the evaluation.

FBOs with multiple U.S. offices may establish an intermediate or regional U.S. reporting line. Such a reporting line should be evaluated to ensure that proper oversight by head office management is achieved.

Formal management reports will usually be generated by control personnel within the branch, independent from line management. Where line managers have input, the senior managers should be well aware of potential weaknesses in the data provided. Risk reporting should be assessed and performed independently of line management to ensure objectivity and accuracy and to prevent manipulation or fraud. For branches operating in a less automated environment, report preparation should be evaluated in terms of timeliness and data accuracy. Cross checking and sign off by the report preparer and reviewer with appropriate authority promote a proper operational controls environment.

Management Information Systems Examination Objectives

Effective date July 1997

Section 3410.2

RISK MANAGEMENT

- To determine if the policies, practices, procedures, and internal controls regarding MIS are adequate.
- To determine that risk management reporting summarizes the quantifiable and non-quantifiable risks of the branch to all appropriate management levels both at the local office and at the head office in a timely manner to ensure compliance with established risk parameters.
- To determine whether management reporting provides adequate information for strategic planning to the extent conducted by local branch management.
- To evaluate computer systems, communication networks, and software applications in terms of their ability to support and control the branch's activities.
- To determine that the functions of automated systems and reporting processes are well understood by staff and are fully documented.

OPERATIONAL CONTROLS

- To determine the scope and adequacy of the audit function for MIS and management reporting.
- 7. To verify that only authorized users have access to automated systems.
- To determine that the software applications relating to risk reporting, pricing, and other applications are fully documented and subject to independent review.
- To determine that the automated systems and manual processes are designed with sufficient audit trails to evaluate and ensure data integrity.

OTHER

 To recommend corrective action when MIS policies, practices, procedures, or internal controls are deficient.

Management Information Systems Examination Procedures

Effective date July 1997

Section 3410.3

These procedures represent a comprehensive list of processes and activities to be reviewed during a full scope examination. The examiner-incharge will establish the general scope of the examination and work with the examination staff to tailor specific areas for review as circumstances warrant. The procedures selected will be based on internal audit comments, previous examination workpapers, a general review of the activity to be examined, and the judgement of the examiner and examiner-in-charge.

- regional management, if applicable. Can branch data be accessed directly by them?
- Review lists of ongoing or planned information systems projects. Determine whether
 the priority of projects is justified given
 branch management's strategic goals and
 the recent mix of business activity.
- 8. Review, for frequency, the branch manager's attendance at periodic meetings with head office to report on branch activities.

RISK MANAGEMENT

- Obtain a flowchart of management reports and system flows, and review information to identify important risk points.
- Review the policies and procedures for MIS and management reporting, including the scope, quality, and frequency of management reports. Determine whether head office management is receiving adequate and timely information to effectively monitor branch operations.
- 3. Review the functional applications such as credit administration, risk monitoring, liquidity and funds management, trade settlement, accounting, revaluation, etc., to determine the combination of automation and manual intervention for management reporting. Compare findings with examiners reviewing specific products or business lines.
- 4. Determine whether the range of risk management reports is adequately documented in terms of inputs (data bases, data feeds external to the branch, economic and market assumptions), computational features, and outputs (report formats, definitions). Evaluate the documentation for thoroughness and comprehensiveness.
- 5. Determine whether the range of reports (risk management, past due and nonperforming loans, financial performance, and operational controls) provides valid results to evaluate business activities and for strategic planning.
- Comment on the branch's automated communications with the head office and/or U.S.

OPERATIONAL CONTROLS

- Obtain copies of internal and external audits for MIS and management reporting. Review findings and management's responses to determine whether appropriate corrective action is taken by management.
- 10. Obtain an overview of the system's functional features with the financial institution's systems administrator. Browse the system with the administrator. Determine whether passwords are used and access to the automated system is restricted to approved users.
- 11. If the branch has a number of independent data bases for credit administration, risk monitoring, etc., determine the types of reconciliations performed, the frequency of data base reconciliation, and the tolerance for variance. Generally, independent data bases have more potential for data error.
- 12. Determine the usage of financial applications on terminals that are not part of the mainframe, minicomputer, or local area network. For example, traders may use their own written spreadsheet to monitor risk exposure or for reconciliation.
- 13. Determine whether the processing and production of reports is segregated from line management and staff. Where line management has influence, how does the branch validate summary data and findings?

OTHER

14. Ensure that the branch has considered the impact of the century date change (year 2000) on its computer systems, and has taken steps to correct any problems. Determine the extent of management's: a. awareness and due diligence

- b. risk assessment
- c. solution implementation and testing
- d. contingency planning

15. Recommend corrective action when policies, practices, procedures, internal controls or MIS are deficient.

Management Information Systems Internal Control Questionnaire

Effective date July 1997

Section 3410.4

RISK MANAGEMENT

- 1. Is management reporting adequate for the volume and complexity of the branch's range of activities? Are reports complete? Do they have clear formats? Are exceptions highlighted?
- 2. Does local and head office management have adequate information to monitor the changing risk profile of the branch? Does the branch have written policies regarding the type and frequency of reports to be submitted to a regional or head office level? Do the reports accurately convey the condition of the branch and the information required in accordance with written policies? How often does branch management communicate with its regional and head offices on an informal basis?
- 3. Is the risk measurement and management system sufficiently flexible to stress test the range of portfolios managed by the branch? Does the system provide usable and accurate output? If the branch does not perform automated stress testing, what process is used to minimize quantifiable risks in adverse markets?
- 4. Do reports provide information on the branch's activities that is adequate for sound planning? Are profitable and unprofitable activities clearly identified?
- 5. Do reports segregate positions by legal entity when appropriate?
- 6. Do policies and procedures address the range of system development and technical maintenance at the branch, including the use of outside vendors and consultants? Does the branch or FBO have a comprehensive computer policy? If the branch uses personal computers, there should be a written policy to address access, development, maintenance, and other relevant issues.
- 7. Are there functional specifications for the system? Are they adequate for the current range of automated systems at the branch? Do they address both automated and manual input and intervention?
- 8. Does the branch have flowcharts or narratives that indicate the data flow from input through reporting? Is this information com-

- prehensive for the level of reporting necessary for the branch?
- 9. Are third party vendors provided with adequate lead time to make changes to existing programs? Is sufficient testing performed before system upgrades are implemented?
- 10. Are planned enhancements or development projects given appropriate priority based on management's stated goals?
- 11. Does the system design account for the different pricing conventions and accrual methods across the range of products in use at the branch? Evaluate the range of system limitations for processing and valuation across the range of products utilized by the branch. Assess the possible impact on accuracy of management reporting.

OPERATIONAL CONTROLS

- 12. Is management reporting prepared on a sufficiently independent basis from line management? Are appropriate segregation of duties in place for report preparation? Is the data accurate?
- 13. Is the scope of the audit coverage comprehensive? Are audits for MIS and reporting available? Are findings discussed with management? Has management implemented corrective action for deficiencies in a timely manner?
- 14. Is access to the automated systems adequately protected?
 - a. Do access rights, passwords, and logon IDs protect key data bases from corruption?
 - b. Are "write or edit" commands restricted to a limited set of individuals?
 - c. Are specific functions assigned to a limited set of individuals? Are access rights reviewed periodically?
 - d. Does the system have an audit report for monitoring user access?
 - e. Is access logon information stored in records for audit trail support?
- 15. Is management information provided from mainframe, minicomputers, local area networks, a single user personal computer, or a combination of the above?

- 16. Identify the key data bases used for the range of management reports.
 - a. Are direct electronic feeds from external services, such as Reuters, Telerate, and Bloomberg employed? How are incomplete data feeds identified? Can market data be overridden by users? How does the branch ensure the data integrity of data feeds or manually input rates, yields, or prices from market sources?
 - b. Are standard instructions set within the automated systems? Can these be overridden? Under what circumstances?
 - c. For merging and combining data bases, how does the branch ensure accurate
 - d. What periodic reconciliations are performed to ensure data integrity? Are

- reconciliation personnel sufficiently familiar with the information to identify "contaminated" data?
- 17. Is the branch's computer system capable of handling year 2000 calculations?

CONCLUSION

- 18. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 19. Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

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OTHER ASSETS

The term "other assets," as used in this section, includes all balance sheet asset accounts not covered specifically in other areas of the examination. Such accounts often may be quite insignificant to the overall size of the branch. However, significant subquality assets may be discovered in accounts of some branches lacking proper internal controls and procedures.

Types of Accounts

Types of other assets frequently found in branches include the various temporary holding accounts such as suspense, teller, transit, and bookkeeping differences having debit balances. Those accounts should be used only for temporary recording, until the offsetting entry is received or fully identified and posted to the appropriate account. Branches will also have more permanent accounts recorded in other assets such as premises and furniture, leasehold improvements, purchased computer software, and deferred payment letters of credit. Nothing should be allowed to remain in the temporary holding accounts ("difference accounts") for any significant length of time, usually no more than a few business days. Branches should have written procedures to ensure that difference accounts are reconciled and closed out on a timely basis. In any event, all difference accounts should be closed out at least monthly.

General categories of other assets common to branches on the accrual system are prepaid expenses and income earned not collected. Prepaid expenses represent cash outlay for goods and services, the benefits of which will be realized in future periods. Income earned and not collected results from the differences between accrual and cash-basis accounting.

There are an unlimited number of account titles that could be included in the other assets category, from bond coupons to art objects, antiques, and coin and bullion. The examiner must design specific procedures for review and testing to fit the particular account and situation and must document the scope of the review in the workpapers.

Scope of other assets review

Examiners assigned to review other assets must obtain a detailed breakdown of such accounts, with a description of each account and the date each item was posted. Certain accounts, such as Other Real Estate Owned, may be reviewed by examiners assigned to other areas of the branch. Refer to Section 3090 for information on other real estate owned. The remaining accounts should be reviewed and evaluated by examiners assigned to this section.

The major factor in deciding which accounts are to be reviewed is materiality; however, even accounts with small balances may require attention. Net balance accounts must be grossed up. The examiner should then evaluate whether to analyze the nature and quality of each individual item based upon its impact on the overall soundness or risk standing of the branch. In this regard, it is important that the examiner verify the existence of the asset, the proper valuation of the asset, the adequacy of the accounting and disposition controls, and the quality of the asset.

An examiner should verify the existence of the assets selected by ensuring adequate supporting documentation. The examiner should also verify that ownership of the asset rests with the branch. The date the asset was acquired or first posted also is important. Temporary accounts such as suspense, should be cleared of stale items.

Proper valuation and reporting of other asset accounts is another potential area of concern for the examiner. Assets are generally acquired through purchase, trade, repossession, prepayment of expenses, or accrual of income. Generally, assets purchased, traded, or repossessed are transferred at their fair market value. Prepaid expenses and income accrued are booked at cost. An examiner should be particularly alert in identifying those assets that lose value over time to ensure that they are appropriately depreciated or amortized. All intangible assets should be regularly amortized, and management should have a system in place to confirm the valuation of the remaining book balance of the intangible assets. The examiner should ensure that the book balance of key personnel life insurance policies owned by the branch value the surrender charge, if any.

The examiner should assess the quality of the asset. Refer to Section 6010.1, Asset Quality Classifications, for information on the classification of assets

The examiner should ensure that the controls concerning other assets protect the branch's ownership rights, that the accounts are properly valued and accurately reported, and that activity is monitored regularly by management. A branch with good controls and review procedures will periodically charge off all uncollectible or unreconcilable items. However, the examiner must frequently go beyond the general ledger control accounts and scan the underlying subsidiary ledgers to determine that posting errors and/or the common practice of netting certain accounts against each other do not cause significant balances to go unnoticed because of the lack of proper detail.

OTHER LIABILITIES

"Other liabilities," as used in this section, include all balance sheet liability accounts not covered in other specific liability categories or in other areas of the examination. The accounts often may be quite insignificant to the overall size of a branch. In some branches, specific accounts are established for control purposes and appear on the balance sheet as other liabilities. For reporting, however, these accounts must be assigned to specific liability categories or netted from related asset categories, as appropriate.

Types of Accounts

A general category of other liabilities common to branches using accrual systems is expenses accrued and unpaid. These accounts represent periodic charges to income based on anticipated or contractual payments of funds to be made at a later date. The accounts include items such as interest on deposits, taxes, and expenses incurred in the normal course of business. There should be a correlation between the amount being accrued on a daily or monthly basis and the amount due on the stated or anticipated payment date.

The examiner should review other liability accounts to determine that accounts, such as deferred taxes (credit balance), are being properly recognized. This review should also determine that matters, such as pending tax litigation, equipment contracts, and accounts payable, have been recorded properly and are being discharged in accordance with their terms and requirements.

Various miscellaneous liabilities may be found within the accounts, such as deferred credits, suspense, and other titles denoting pending status. The number of possible items that could be included are unlimited and the accounts should be reviewed to determine that they are used properly and that all such items are clearing in the normal course of business. Because of the variety of such accounts, the examiner must develop specific examination procedures to fit the particular account and situation.

Scope of other liabilities review

Examiners assigned to review other liabilities are responsible for obtaining the branch's breakdown of those accounts and determining when they are to be reviewed under other sections of this manual. They must ensure that examiners in charge of those other sections receive the necessary information. The remaining accounts should be reviewed and evaluated by examiners assigned to this section.

The major emphasis in examining this area should be on the adequacy of the controls and procedures employed by the branch in promptly recording the proper amount of liability. Without proper management attention, these accounts may be misstated, either advertently or inadvertently. For instance, fraudulent entries in suspense or interbranch accounts could be rolled over every other day to avoid stale dates causing shortages to be effectively concealed for indefinite periods of time.

Like other assets, other liability accounts with small balances may be significant and net balance accounts should be grossed up. Scanning account balances may disclose a recorded liability but it does not aid in determining whether liability figures are accurate. Therefore, it is important to review information obtained from branch counsel handling litigation because these documents might reveal a major understatement of liabilities. Determining accurate balances in other liability accounts requires an in-depth review of source documents or other accounts from which the liability arose.

Other Assets and Other Liabilities Examination Objectives

Effective date July 1997

Section 3420.2

- To determine if policies, practices, procedures, and internal controls regarding other assets and other liabilities are adequate.
- 2. To determine that branch officers and employees are operating in conformance with established guidelines.
- To evaluate the validity and quality of all other assets.
- 4. To determine that other liabilities are properly recorded.
- 5. To evaluate the scope and adequacy of the audit function.
- 6. To determine compliance with laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Other Assets and Other Liabilities Examination Procedures

Effective date July 1997

Section 3420.3

- Complete or update the Internal Control Questionnaire, if selected for implementation.
- Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
- 3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review by internal/external auditors from the examiner assigned to Internal and External Audits, and determine if appropriate corrections have been made.
- 4. Obtain a trial balance of other asset and other liability accounts and:
 - a. Verify or reconcile balances to departmental controls and general ledger.
 - b. Review reconciling items for reasonableness.
- 5. Scan the trial balances for:
 - a. Obvious misclassifications of accounts and, if any are noted, discuss reclassification with appropriate branch personnel and furnish a list to appropriate examining personnel.
 - Large, old, or unusual items and, if any are noted, perform additional procedures as deemed appropriate being certain to appraise the quality of other assets.
 - c. Other asset items that represent advances to related organizations, officers, employees or their interests, and, if any are noted inform the examiner assigned to Credit Risk Management.
- Determine that amortizing other asset accounts are being amortized over a reasonable period relative to their economic life.

- If the branch has outstanding customer liabilities under deferred payment letters of credit, obtain and forward a list of names and amounts to the examiner assigned to Credit Risk Management.
- 8. Review the balance of any other liabilities owed to officers or their interests and investigate, by examining applicable supporting documentation, whether they have been used to record unjustified amounts or amounts for items unrelated to branch operations.
- Develop and note in the workpapers any special programs considered necessary to properly analyze any remaining other assets or other liabilities account.
- 10. Test for compliance with applicable federal and state laws and regulations.
- 11. For other asset items that are determined to be stale, abandoned, uncollectible, or carried in excess of estimated values and for other liability items that are determined to be improperly stated, request management to make the appropriate entries on the branch's books after consulting with the examiner-in-charge.
- 12. Prepare in appropriate report form and discuss with appropriate officer(s):
 - a. Violations of laws and regulations.
 - b. Criticized other assets.
 - c. The adequacy of written policies relating to other assets and other liabilities.
 - d. Recommended corrective action when policies, practices, or procedures are deficient.
- Update the workpapers with any information that will facilitate future examinations.

Other Assets and Other Liabilities Internal Control Questionnaire

Effective date July 1997

Section 3420.4

Review the branch's internal controls, policies, practices, and procedures concerning other assets and other liabilities. The branch's systems should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

- 1. Has the branch formulated written policies and procedures governing both other asset and other liability accounts?
- 2. Does the branch maintain subsidiary records and supporting documentation of items comprising other assets and other liabilities?
- 3. Is the preparation of entries and posting of subsidiary other asset and other liability records performed or tested by persons who do not also have direct control, either physical or accounting, of the supporting data or related assets?
- 4. Are the subsidiary records balanced at least monthly to the appropriate general ledger accounts by persons who do not also have direct control, either physical or accounting, of the supporting data or related assets?
- 5. Are the items included in suspense accounts aged and regularly reviewed for propriety by responsible personnel?
- 6. Are receivables reviewed at least monthly for collectibility by someone other than the originator of the entry?

- 7. Is approval required to pay credit balances in receivable accounts?
- 8. Do credit entries to receivables accounts, other than payments, require the approval of an officer independent of the entry preparation?
- 9. Does charge off of a nonamortizing other asset initiate review of the item by a person not connected with entry authorization or posting?
- 10. Are invoices and bills proved for accuracy, prior to payment? Who has the authority to pay the invoices and up to what amount?
- 11. Are all payroll tax liabilities verified to appropriate tax returns and reviewed by an officer to ensure accuracy?

CONCLUSION

- 12. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Other Assets and Other Liabilities Audit Guidelines

Effective date July 1997

Section 3420.5

- Obtain or prepare detailed lists of other assets and other liabilities, including a breakdown of subsidiary ledgers.
- Within each category of other assets, use an appropriate sampling technique to select specific items and:
 - a. Where appropriate, verify the original balance of the item from an invoice or other supporting document.
 - b. Examine documentation for additions to any given item since the previous audit.
 - c. Where amortization is applied to a given item, review the computations for the period since the previous audit to determine mathematical accuracy and the reasonableness of estimated life.
 - d. Determine the reasonableness of the current balance by reviewing the remaining estimated life, collectibility, etc.
 - e. Prepare any special programs considered necessary to properly analyze and test specific accounts.
- 3. Determine that interbranch and affiliate transactions clear in the normal course of business by actually reviewing the entries to the account for several days and examining the debit and credit tickets. Special attention should be given to entry dates, authorizing initials, and validity or reasonableness of the item.
- 4. If a branch is on an accrual basis of accounting:
 - Review the branch's system of recording liabilities for interest, taxes, and other expenses.

- Review the balance of interest accrued to outstanding interest-bearing liabilities for reasonableness.
- c. Review the balance of the reserve for both current and deferred taxes for reasonableness by examining the worksheets and computations.
- d. Review the reasonableness and completeness of the balance reflected for reserves for other expenses.
- 5. Within each general category of other liabilities, use an appropriate sampling technique to select specific items for further review. For each item selected, determine that the balance is reasonably stated by examining supporting documentation.
- Review accounts not sampled, for items that appear unusual in nature or amount and examine supporting documentation.
- Using an appropriate sampling technique, select expense checks issued since the examination date and:
 - Determine whether the expense was incurred before or after the examination date by examining the vendor's invoice or other supporting documentation.
 - For expenses incurred prior to the examination, trace the amount to the detail list of other liabilities.
 - Discuss with appropriate branch officials, any significant items incurred prior to and recorded after the examination date.

Effective date July 1997

This section describes the activities of private banking services and provides insight into adequate safeguards. The portions concerning hold mail, dormant accounts, and overdrafts are also applicable to the Deposit Accounts section of this manual because they can affect all types of accounts and account holders.

Private banking departments may offer a wide array of products and services to their clients, including, but not limited to, trust services (by referral to or in association with an affiliated trust entity), investment advisory services, foreign exchange trading, lending, letters of credit, bill paying, credit cards, and deposit services. Private banking generally markets its services to high net worth individuals and, if the client has a business, may entice them to develop a corporate banking relationship. Private banking accounts may be opened in the name of an individual, a commercial business, a trust, or a private investment corporation (PIC) registered in offshore havens.

The relationship between the private banker and the client is carefully cultivated by the banker; therefore, it is common for clients to follow private bankers to different financial institutions because of the level of trust that has been developed. As a result, private banking clients may delegate a significant amount of discretionary financial authority to private bankers. Some private banking departments have small staffs that make the segregation of duties normally found in banking activities difficult to maintain. This combination of trust in the private banker and difficulty in segregating duties exposes private banking activities to possible account manipulation. As a result, the private banking area must have compensating internal controls to ensure proper supervision and safeguarding of client accounts.

Examiners should understand the nature and scope of the private banking activities. Additionally, examiners should carefully evaluate the policies, procedures, internal controls, credit reviews, and audits surrounding private banking to ensure that internal controls exist to detect fraud and prevent losses to both the branch and/or customers. Internal and external audits should provide an excellent source of information concerning the adequacy of policies, procedures and controls of private banking. The lack of an internal audit of the private banking

department should be viewed as a serious weakness and criticized in the examination report.

REVIEW OF DEPOSIT ACCOUNTS AND REVIEW OF ACCOUNT DOCUMENTATION

Private banks often assist clients in forming shell corporations of PICs. PICs are generally incorporated in bank secrecy (tax haven) countries such as the Cayman Islands, Bahamas, British Virgin Islands, and Netherlands Antilles to maintain the clients' confidentiality, and/or for tax or trust related reasons. The beneficial owners of the shell corporations are typically foreign residents.

Reviewing the list of accounts for private banking clients may provide insight into some of the activities conducted by private banking. For instance, the review may reveal that the branch allows accounts that disguise the true identity of the client through the use of fictitious or code name accounts, accounts in the name of a PIC, or blind/numbered trust accounts. Management must be able to provide documented files on the identity of the ultimate account holder and details on the account relationship. Examiners should carefully scrutinize the reasons for these types of accounts and ensure that they do not compromise the institution's compliance with the Financial Recordkeeping and Reporting regulations, and the Federal Reserve's "Know Your Customer" guidelines.

Reviewing account documentation should reveal that the branch has an adequate quality control program in place for opening accounts that includes a follow-up system for obtaining missing or date-sensitive documents. Additionally, account documentation reviews should show how the branch documents its client relationships and implements its "Know Your Customer" policy.

An integral part of an effective "Know Your Customer" policy is a comprehensive knowledge of both the customer and the types of transactions carried out by the customer. As a general rule, a financial institution should never establish a business relationship until the identity of a potential customer is satisfactorily verified. Accordingly, the "Know Your Customer" policy should clearly identify the type of documentation needed before a relationship can

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be formerly established. If a potential customer refuses to produce any of the requested information, the relationship should not be established. Likewise, if requested follow-up information is not forthcoming, any relationship already begun should be terminated.

The purpose of the business relationship should also be identified. Incoming client funds may be used for various purposes such as establishing deposits, funding investments, securitizing loans, paying bills, or establishing PICs or trusts. The "Know Your Customer" procedures established by the institution allow for the collection of sufficient information to develop a "transaction profile" for each customer. The primary objective of such procedures is to enable the institution to predict with relative certainty the types of transactions in which a customer is likely to engage. Internal systems should then be developed for monitoring transactions which are inconsistent with the customer's transaction profile. The level, detail and documentation of "Know Your Customer" information should be greater for customers with larger balances and transaction volumes. (Examiners may refer to the Federal Reserve's Bank Secrecy Act Manual and other similar examination material for more information).

HOLD MAIL

Private banking clients and in particular, international private banking clients, are often provided hold mail service. Hold mail clients elect to have bank statements and other documents maintained at the institution rather than mailed to their home address. In most cases, this service is provided because the client's country of residence has an unreliable or limited postal system or for security reasons. Controls over hold mail accounts should be carefully reviewed because the clients do not receive their statements promptly, and therefore, relinquished their ability to detect unauthorized transactions in a timely manner. One of the key controls that should be part of any hold mail operation is to have a process for ensuring that the back office receives customer account statements.

DORMANT ACCOUNTS

Accounts that are inactive for a prolonged period of time could be subject to manipulation and

abuse by branch personnel. Examiners should carefully review the policies, procedures, and controls over dormant accounts. Effective controls over dormant accounts should include:

- A specified period of time between the last customer-originated activity and its classification as dormant.
- Segregation of signature cards for dormant
- Blocking of the account so that entries cannot be posted to the account without review by more than one member of senior management outside of private banking.

OVERDRAFTS/EXTENSIONS OF CREDIT

Private banking clients often pledge their assets, including cash, mortgages, marketable securities, land, and/or buildings to securitize loans. Loan proceeds are used for a variety of purposes, including, but not limited to, recapitalizing the client's business(s) or providing working capital. Branch management should demonstrate understanding of each specialty business and should know what would affect the value of any collateral or business being financed. Loans to private banking clients may not be of sufficient size to be covered during the review of asset quality. However, it is important to ensure that a sampling of private banking loans and contingent liabilities are reviewed. In many instances, loans and other credit-related activities for private banking clients are collateralized by cash or marketable securities; therefore, credit underwriting standards and procedures may not be as complete or stringent as prudent banking practice would dictate.

Loans backed by cash or negotiable collateral are common in private banking. An extension of credit based solely on collateral, even if the collateral is cash, does not guarantee repayment. There are at least three ways in which a branch can lose its collateral: forfeiture through the seizure of assets by a government agency; theft or manipulation by a dishonest employee; and errors such as the inadvertent release of collateral by an employee. While the collateral enhances the branch's position, it should not be used as a substitute for regular credit analyses and prudent lending practices unless the branch makes a separate determination of the creditwor-

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thiness of the client. A client may be considered creditworthy if the branch performs its due diligence by adequately documenting that its client's funds were derived from legitimate means and can verify that the use of the loan proceeds are for legitimate purposes.

Examiners should ensure that policies and procedures for extending credit to private banking clients are in place and are being followed. The branch's credit review function should also sample private banking loans and ensure compliance with established policies. Loan files should contain sufficient information to assess the quality of the credit, the proper approvals, and the purpose and source of repayment. During the review of private banking loans, examiners should ensure that loan files include documented background information on the client's source of wealth and occupation, the purpose of the loan, and the source of repayment (other than collateral). Ambiguous purposes such as personal investments or working capital, and liquidation of cash collateral for source of repayment, are generally not acceptable. Weaknesses in this area could result in noncompliance with the Financial Recordkeeping and Reporting regulations (See the Federal Reserve's Bank Secrecy Act Manual and other similar examination material for details).

Loans secured by cash or marketable securities should have files containing pledge/assignment documents, which serve to perfect the branch's security interest. In addition, procedures should be implemented to monitor and document the value of the collateral. Documentary exceptions should be listed as technical exceptions.

Documented financial statements that support credit decisions and guarantees may be present. Financial statements should never be waived merely because the loan is secured by cash or marketable securities.

BILL PAYING SERVICES

Private banking departments often provide bill paying services for their clients. If this service is provided, examiners should ensure that an agreement between the customer and the client exists for this service and that it has been reviewed by legal counsel. Typically, a client might request that the branch debit a deposit account for credit card bills, utilities, rent, mortgage payments, or

other monthly consumer charges. Policies, procedures, and controls over this area should be reviewed to ensure that they are adequate and protect the customer and the branch from fraud or abuse.

SALE OF NON-DEPOSIT INVESTMENT PRODUCTS

Private banking departments are increasingly offering investment products to their clients under discretionary or nondiscretionary arrangements. In addition, private banking departments may also offer treasury services, portfolio management, financial planning advice and offshore services.

Although fiduciary and agency activities are circumscribed by formal trust laws, clients may delegate varying degrees of authority (discretionary versus nondiscretionary) over assets under management to the institution. In all cases, the terms under which the assets are managed are fully described in a formal agreement, also known as the "governing instrument", between the customer and the institution. The agreement should address the duties that a fiduciary is obliged to perform for its beneficiaries or customers, keeping the assets of the customers separate and distinct from those of the branch, and avoiding any circumstances that may conflict with the branch's fiduciary obligations. A client's portfolio may consist of a mixture of instruments bearing varying degrees of market and credit risk which should be appropriate to the client. Assets under management may include deposits, securities, loans, items held in safekeeping, and other products.

Examiners should determine, through discussions with private banking personnel, the types of products being offered to clients. Clients may be offered a wide range of products. Examiners should also determine the level of discretionary authority delegated to private banking personnel in the management of these activities and the documentation required from customers to execute transactions on their behalf. Private banking personnel should not be able to execute transactions on behalf of their clients without proper documentation from clients or independent verification of client instructions.

On February 16, 1994, federal and thrift regulatory agencies released a joint statement on

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retail sales of mutual fund and other non-deposit investment products by federally insured institutions. It reaffirms the agencies belief that retail customers must be fully informed about risks associated with non-deposit investment products. Branches recommending or selling such products should ensure that customers are fully informed that the products: (1) are not FDICinsured; (2) are not deposits or other obligations of the institution and are not guaranteed by the institution; and (3) involve investment risks, including possible loss of principal. Examiners should refer to this statement for further guidance. While this statement addresses insured branches, the premises in this statement are applicable to uninsured branches.

Examiners should ensure that the branch has agreements with customers covering the terms of any asset management or other services provided, and that the agreements are on file. An evaluation of private banking personnel's ability and competence to provide the services offered should also be assessed. If the branch executes transactions or performs back-office functions, the examiner should refer to the Securities Activities section of this manual for further guidance.

Private Banking Examination Objectives

Effective date July 1997

Section 3430.2

- To determine if policies, practices, procedures, and internal controls covering private banking activities are adequate and are being followed by branch personnel.
- 2. To determine the scope and adequacy of the audit function.
- To recommend corrective action when policies, procedures, practices, or internal controls are deficient or when violations of laws or regulations have been noted.

Private Banking Examination Procedures

Effective date July 1997

Section 3430.3

The examiner should refer to the sections of this manual listed below as well as other applicable supervisory agency manuals for further information on examination procedures:

- Deposit Accounts section for examination procedures covering deposit accounts, hold mail, dormant accounts and overdrafts.
- Credit Risk Management section for examination procedures for extensions of credit.
- Federal Reserve's Bank Secrecy Act Manual or other similar examination material for examination procedures to check private banking activities for compliance with the Financial Recordkeeping and Reporting regulations.

The various state and federal agencies may differ in terms of specific practices and methodologies used to implement the following guidelines. For further guidance in this area, examiners should consult with their respective agencies.

- 1. If selected for implementation, complete or update the internal control questionnaire.
- Review policies and procedural manuals, and internal control activities to determine their adequacy.
- 3. Assess the adequacy of the internal audit function as it relates to private banking.
- 4. Determine, through a discussion with management, what types of products are offered to private banking clients.
- Review the agreements covering the products offered by private banking to determine that they adequately protect the branch and the customer.
- Assess private banking personnel's level of competency to provide the services being offered to clients, i.e., education, experience, licenses, and the branch's training program.

Private Banking

Internal Control Questionnaire

Effective date July 1997

Section 3430.4

POLICIES AND PROCEDURES

- Does the branch have up-to-date policies and procedures regarding private banking activities?
- 2. Do the policies and procedures cover the following:
 - a. Definition of the products offered.
 - b. Client account opening procedures.
 - c. Client background checking procedures.
 - d. Account monitoring procedures.
 - e. Token name account requirements.
 - f. Account officer's responsibilities.
 - g. Documentation requirements.
 - h. Segregation of duties.

OFFICE OF FOREIGN ASSETS CONTROL AND REGULATION

 Are private banking customers reviewed against the Office of Foreign Assets Control and Regulation's (OFAC) listing of blocked accounts of foreign individuals and countries? (Refer to the Other Compliance Matters section of this manual for more information on OFAC).

TOKEN NAMES

- 4. Does the branch maintain a listing of all token name accounts and is there sufficient documentation to ascertain the customer's "true" identity?
- 5. Does management periodically review all accounts?
- 6. Are there agreements on file that adequately outline the branch's powers and limits of liability?

MANAGEMENT INFORMATION SYSTEMS

7. Are complete and accurate management reports received by private banking administrators and senior management on a timely basis?

- 8. Do the management reports cover the following:
 - a. Credit.
 - b. Overdrafts.
 - c. Cash and deposit activity.
 - d. Limit exceptions.
 - e. Past-due accounts.
 - f. Missing documents.
 - g. Daily activity.
 - h. Off-balance-sheet exposure (e.g., letters of credit).
 - i. Sale of non-deposit investment products.

AUDIT COVERAGE

- 9. Does the audit report provide management with an adequate appraisal of the private banking function?
- 10. Does the audit report cover all of the necessary control concerns and procedures listed in this internal control questionnaire?
- 11. Do management responses indicate that prompt and appropriate corrective action is taken when exceptions are noted?

DEPOSIT ACCOUNTS

Refer to the Deposit Accounts section of this manual when reviewing deposit account activities managed by the private banking staff.

HOLD MAIL

- 12. Does the branch have a "hold harmless" statement for hold mail accounts? Are hold mail accounts tested to ensure hold harmless statements are on file and are signed by customers?
- 13. Are hold mail statements kept in a secured area and segregated from the private banking area?
- 14. How is hold mail released to customers? (It should not be given to private bankers to deliver to the customer).
- 15. Are customers required to sign a form acknowledging receipt of their hold mail? Is the signature verified against signature

- cards? Does the form list what mail was received?
- 16. What items are kept in hold mail files?
- 17. Are hold mail customers required to pickup hold mail within a specified period? What procedures are followed if hold mail is not picked up within specified periods?
- 18. Does an adequate audit trail exist in the hold mail area?
- 19. Does the internal audit function adequately review the hold mail function?

Refer to the Deposit Account section of this manual for more questions.

DORMANT ACCOUNTS

- 20. Over what time period does an account become dormant? Are dormant accounts blocked on the computer system or are all transactions on dormant accounts reviewed for authenticity?
- 21. If the appropriate time defining a dormant account has elapsed and the account is not placed on dormant status, is the reason documented?
- 22. Are signature cards for dormant accounts segregated and under dual control?
- 23. Who maintains the list of dormant accounts and is there dual control/segregation of duties in place to reactivate dormant accounts? Does the reactivation require approval from an officer outside the private banking department?
- 24. Does the branch comply with the escheating State requirements for dormant accounts?
- 25. Does the internal audit function review for compliance with dormant account procedures?

Refer to the Deposit Account section of this manual for more questions.

OVERDRAFTS

26. Is there an overdraft approval schedule with limits for each officer? Are the limits reasonable?

- 27. Is the overdraft report reviewed and signed by management on a daily basis? If not, when is it reviewed? Are approvals within established limits?
- 28. Is there an overdraft aging report and is it reviewed by management?

Refer to the Deposit Accounts section of this manual for further questions.

BILL PAYING SERVICES

- 29. Is there an agreement between the customer and the branch covering bill paying services? Does it specify what bills are to be paid?
- 30. What support documents are required as back-up for bill payments?
- 31. Are there adequate dual controls and review of the bill paying function?
- 32. Is confidential bill paying information, such as credit card numbers with expiration dates, safeguarded?
- 33. Are official checks used for bill paying properly controlled and inventoried?

CREDIT CARDS

- 34. Does the branch provide credit cards to its customers?
- 35. Are there adequate procedures to safeguard the cards while they are in the branch's custody?
- 36. Does the customer acknowledge receipt of the card upon delivery?

CONCLUSION

- 37. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 38. Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Operational Controls Introduction

Effective date July 1997

Section 4000.1

Operational risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in losses or compromise the financial or reputational integrity of the FBO.

The "O" component of ROCA assesses the effectiveness of the branch's operational controls, including accounting and financial controls. The assessment is based on the expectation that branches should have a system of internal controls consistent with the size and complexity of their operations. This system is complemented by an independent internal audit function that may range from an internal system of self-checks to a system that includes head office audits or external audits. In this regard, internal audit and control procedures should ensure that operations are conducted in accordance with internal guidelines and regulatory policies. In addition, controls should be in place to ensure that all reports and analyses provided to the head office and branch senior management are timely and accurate.

An institution's internal control structure is critical to the safe and sound functioning of the organization, in general, and to its risk management system, in particular. Establishing and maintaining an effective system of controls is one of management's more important responsibilities. These controls include the enforcement of official lines of authority, and the appropriate separation of duties in areas such as trading, custodial, and back-office. Appropriately segregating duties is probably the most fundamental and essential element of a sound internal control system. Failure to implement and maintain adequate separation of duties is an unsafe and unsound practice and can lead to serious losses or compromise the financial and reputational integrity of the institution. Serious lapses or deficiencies in internal controls may warrant supervisory action, including formal enforcement action. When properly structured, internal controls promote effective operations, produce reliable financial and regulatory reports, safeguard assets, and ensure compliance with laws, regulations, and internal policies and procedures.

Ideally, internal controls are tested by an independent internal auditor who reports directly to the regional or head office. However, smaller

institutions, where size and complexity do not warrant a full scale internal audit function, may rely on regular reviews of essential internal controls conducted by other institution personnel. Personnel performing these reviews should be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to them. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the FBO's senior management.

Because the audit function is an integral part in the branch's assessment of its internal control system, examiners must review the control environment at every examination. These reviews assist in the identification of significant risks, and facilitate a comprehensive evaluation of the branch's internal control structure. These reviews also provide information for determining the procedures to be completed during the examination. In addition, examiners should evaluate the independence and competence of the personnel conducting control assessments and should meet with the internal auditors or other personnel and review internal control risk assessments, work plans, reports, and workpapers.

When examiners detect significant internal control weaknesses, affecting both the "O" component rating as well as the composite rating, special audit procedures may be required. Supervisory policy (SR 96-27) offers guidance for the implementation of special audit procedures intended to reduce the risk of losses due to misconduct or fraud, and to promote prompt correction of situations that can cause an unsafe and unsound banking environment. Significant internal control weaknesses in the operations of one office may be an indication that similar weaknesses exist at other offices of the FBO. To ensure proper supervision, the coordinating Reserve Bank, in consultation with other federal and state regulatory authorities, will determine to what extent the special audit procedures should be applied to the other U.S. operations of the FBO. In some cases, it may be acceptable to have the special audit procedures performed by

the internal audit staff of the branch. However, if the adequacy of the internal audit function is among the reasons why internal controls are considered to be less than satisfactory, the procedures must be conducted by regional or head office audit staff, or by external auditors as specified in SR 96-27.

Effective date July 1997

This section provides guidelines and criteria for understanding and evaluating the work performed by internal and external auditors and home country regulators. For information on internal loan review, refer to the Credit Risk Management section of this manual.

INTERNAL AUDITS

An internal audit program, fully adequate to the branch's asset size, complexity of operations, and type of risk exposures is a key factor in evaluating the branch. In instances where the branch is too small to support an internal auditor, alternative means of providing coverage must be substituted. One alternative would be periodic visits by head office or regional headquarters auditors who would perform an internal review or evaluation. Another option would be to outsource the internal audit function to an independent accounting or consulting firm whose scope includes a review of internal controls along with a financial review. No matter who administers the internal audit program, the guiding criteria on which to evaluate its adequacy should be the frequency and scope of the coverage of the branch's high risk areas based on a risk assessment. Its adequacy will have a bearing on the evaluation of the branch's operational controls and compliance components.

Internal auditors are responsible for assessing the soundness and adequacy of a branch's accounting, operating, and administrative controls. The assessment is intended to ensure that these controls promptly and accurately record transactions and properly safeguard assets against loss. Additional responsibilities of internal auditors should include determining the bank's compliance with applicable laws and regulations, evaluating the effectiveness of administrative controls and procedures, and evaluating the efficiency of operations.

Internal auditors perform tests and other procedures as part of their audit program that enable them to reach their conclusions. In many instances, audit programs include internal control questionnaires and audit procedures similar to those found in this manual. Detailed standards have been promulgated by professional associations of internal auditors, such as the Bank Administration Institute (BAI) and the Institute of Internal Auditors (IIA). These stan-

dards were used as a guide in developing the Internal, External, and Regulatory Audit Examination Procedures and Audit Function Ouestionnaire.

Some of the factors that should be considered by the examiner in reviewing and evaluating the internal audit function are the independence and competence of the internal auditors and the effectiveness of the audit program. In addition, the examiner should review the internal audit reports completed since the last examination and management's responses.

Independence of Internal Auditors

The ability of the internal audit function to achieve its audit objectives depends, in large part, on the independence maintained by audit personnel. Frequently, the independence of internal auditors can be determined by the reporting lines within the organization and to whom or at what level audit results are reported. In most circumstances, the internal audit function at the branch is under the ultimate direction of the FBO's chief internal auditor and/or executive management or a committee thereof.

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

Competence of Internal Auditors

The responsibilities and qualifications of internal auditors may vary depending on the size and complexity of a branch's operations and on the emphasis placed on the internal audit function by the FBO. In many branches, the internal audit

function is performed by an individual or group of individuals whose sole responsibility is internal auditing. In other branches, particularly small ones, internal audit may be performed by head office or regional auditors.

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

- Academic credentials comparable to other branch officers, who have major responsibilities within the organization;
- Commitment to a program of continuing education and professional development;
- Audit experience and organizational and technical skills commensurate with the responsibilities assigned;
- · Oral and written communication skills: and
- An understanding of the audit objectives and procedures performed by the audit staff.

In considering the competence of the internal audit staff, the examiner should review the educational and experience qualifications required by the FBO for filling positions in the internal audit department, certified proficiency by a professional association, and the ongoing training available for those positions. The examiner should also review and assess the ability of the auditor to check compliance with U.S. laws and regulations.

In a small branch, the internal audit function may be a one-person department hired on a full or part time basis. The internal auditor may plan and perform all procedures personally or may direct staff borrowed from other departments. In either case, the examiner should expect, at a minimum, that the internal auditor possesses qualifications similar to those of an audit department manager as previously discussed.

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

Internal Audit Program Adequacy and Effectiveness

The examiner should consider the following factors when assessing the adequacy of the internal audit program:

- · Scope and frequency of the work performed;
- · Risk-based assessments that tailor scope;
- Parties contributing to the audit program's objectives and scope;
- · Documentation of the work performed;
- · Conclusions reached and reports issued; and
- · Management's response to audit findings.

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

To further assess the adequacy and the effectiveness of the internal audit program, it would be ideal to obtain the audit work programs and analyses that clearly indicate the procedures performed, the extent of testing, and the basis for the conclusions reached; however, this information is not always available to the examiner.

Work programs serve as the primary evidence of the audit procedures performed and, as such, they should be written and should cover all areas of a branch's operations. Each program should provide a clear, concise description of the audit work required, and individual audit procedures should be presented in a logical manner. The detailed procedures included in the program will vary depending on, among other factors, the size and complexity of the branch's operations. Typical audit procedures include the:

- Use of surprise examinations, where appropriate;
- Maintenance of control over records selected for audit:

- Evaluation of the branch's policies and procedures and the system of internal control;
- Verification of selected transactions and/or balances by the review of supporting documentation, and/or direct confirmation and appropriate follow-up of exceptions.

The internal auditor should follow the specific procedures included in all work programs to reach audit conclusions that will satisfy the related audit objectives.

Internal Audit Report Standards

The auditor has a responsibility to report the results of all audit work performed. Some auditors prefer to report only significant exceptions; however, this practice reinforces a negative view of the audit function. The auditor's responsibility to evaluate control systems and ongoing operations carries with it an obligation to report the results of that evaluation. Without a report, management does not have positive assurance that auditing is meeting its commitments. Consequently, management can only assume that adequate coverage is maintained and that the systems of control are functioning adequately, effectively, and efficiently.

Each audit report should contain an opinion on the adequacy, effectiveness, and efficiency of the systems of control and the quality of ongoing operations; the degree of compliance with previously evaluated systems of control, or an explanation of why an opinion cannot be expressed. Each auditor should develop standard language for rendering an opinion. Standardization of language minimizes misunderstanding and promotes recognition of circumstances that require responsive action. When an adverse opinion is expressed, the report shall contain a statement about the exposures that may exist in the absence of corrective action.

Every audit report should identify the area audited and disclose all matters that the auditor believes require responsive action by the recipient. Auditors should clearly distinguish between those matters to which they take exception and those that are reported for other reasons. The degree of detail reported is largely a matter of judgment, influenced greatly by the preferences of management. Sometimes, management prefers to have all audit findings reported, no matter how minor. At other times, management prefers

only a general description of significant findings. Auditors must bear in mind that their ultimate accountability demands that findings of major significance be brought to the attention of senior management at the branch and head office.

The standards do not require the auditor to recommend corrective action. In practice, however, auditors find that management often expects suggestions for corrective action, particularly when the technical aspects of controls are involved. By suggesting corrective action, the auditor demonstrates a positive approach to the organization's problems. In making suggestions, auditors should recognize that their recommendations may not be the only means of achieving the control purpose intended. The focus of concern should be the control purpose and not the particular means selected from a range of acceptable choices.

The timeliness with which audit findings are reported is very important and often critical for effective response. When timeliness is critical, the auditor should communicate findings promptly and not await the preparation and completion of a formal report. Findings should be communicated to the manager whose operation is directly affected and appropriate head office management.

The extent and frequency of audit reports required by head office varies with the organization. At least annually, however, the auditor for the branch should formally report to head office management directly responsible for the branch. Head office is entitled to a report that measures audit performance against plan and provides information normally required to establish accountability. The auditor should use this opportunity to promote an understanding of the audit function and how it serves the organization.

Internal Audit Review

The Examination Procedures section describes the steps the examiner should follow when conducting a review of the work performed by the internal auditor.

The examiner's review and evaluation of the internal audit function is a key element in determining the scope of the examination. In most situations, the competence and independence of the internal auditors may be reviewed on an overall basis; however, the adequacy and

effectiveness of the audit program should be determined separately for each examination area.

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

The frequency of internal audit procedures should be based on an evaluation of the risk associated with each area of interest. There may be situations in which the associated risk is considered minimal due to the materiality of the amounts involved, the internal control procedures followed, the bank's history in a particular area, or other factors.

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

EXTERNAL AUDITS

The objective of an external financial audit is different from the objectives of an internal audit or a branch examination. The examiner is interested in the work performed by external auditors for three principal reasons. First, situations will arise where internal audit work is not being performed or where such work is deemed to be of limited or no value to the examiner. Second, the work performed by external auditors may affect the amount of testing the examiner must perform. Third, audits and other reports rendered by external auditors often provide the examiner with information pertinent to the examination of the branch. The major factors that should be considered in evaluating the work of external auditors are similar to those applicable to internal auditors, namely, the competence and independence of the auditors and the adequacy of the audit program.

Many U.S. branches and agencies of FBOs are required by state law or the head office to have certain audit procedures performed periodically.

For insured depository institutions, FDICIA, through its amendments to the FDIC Act, requires annual independent audits for all FDIC-insured banks and insured branches that have total assets in excess of \$500 million.

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

External auditors frequently conduct financial audits and certain other procedures and services. In the case of financial audits, these must be conducted by Certified Public Accountants (CPAs) in conformance with applicable professional standards. Occasionally, however, nonfinancial reviews may be performed by individuals who are not CPAs but who are familiar with the service or operational requirements in question. In other instances, head office may consider the internal audit program sufficient to satisfy the requirement. Head office should participate in the audits, at least to the extent of appraising the FBOs' policies and the procedures used to attain policy objectives, including the review of any applicable regulatory report of examination with the auditors.

External auditors and consultants are often engaged to conduct in-depth reviews of the operations of specific departments, such as commercial loans or data processing. Such reviews might focus on operations procedures, personnel requirements, or other specific areas of interest. Upon completion of such reviews, the auditors may recommend that the branch, among other things, strengthen controls and/or increase efficiency. External auditors and other specialists may be employed to assist management in specialized fields, such as taxation and management information systems.

External Audit Opinions

The external auditor generates various types of opinions and other documents, which typically include:

 The standard unqualified opinion, generally a one-page document.

- A management letter in which the auditor confidentially presents detailed findings and recommendations to management.
- Reports from the auditor to regulators during the audit period.

The major types of standard audit opinions are not explicitly identified by the auditor. These opinions will generally not have a heading or other statement in the report that identifies its type. Terminology used in the report suggests the type of opinion issued. The major types of standard audit opinions and brief examples of corresponding text are as follows:

- The unqualified opinion—sometimes referred to as a "clean opinion." This type states that the financial statements are "presented fairly" in conformity with GAAP and that the necessary audit work was done. This report is often referred to as the standard audit report and may include additional explanatory language regarding particular issues.
- The qualified opinion—indicates that financial statements are presented fairly in all material respects "except for" the effects of a particular matter. Such matters may include the lack of sufficient evidential matter, restrictions on the scope of audit work, or minimal departures from GAAP in preparing the financial statements. This type of report is not necessarily negative but indicates that the examiner should ask additional questions of management.
- A disclaimer—expresses no opinion on the financial statements. CPAs may issue a disclaimer when they have concluded that substantial doubt surrounds the means used to compile financial statements but that no conclusive evidence pinpointing the type of nonconformance to GAAP could be identified. This disclaimer is intended to indicate that the CPA is not assuming any responsibility for these statements.
- An adverse opinion—concludes that the financial statements are not presented fairly or are in "significant nonconformance with U.S. GAAP." Disclaimers may also be issued when auditors have concluded that the scope of their review has been significantly restricted.

Engagement Letters

A branch should require that external auditors submit engagement letters to the branch or its

head office before commencing their work. Such letters include, among other things, the scope of the audit, the period of time to be covered by the audit, and the reports expected to be rendered. In many cases, the highlights of these matters will be summarized in the body of the letter with greater detail being provided in schedules or appendices to the letter. Procedures may be specific by audit area. That is, the auditor may provide a capsulized description of procedures with regard to cash and due from banks, loans, deposits, etc. In addition, if there are any limitations on the scope of the audit, the letter may specify any auditing procedures that are to be omitted, such as confirmation of loans or deposits, if the auditor is expected to render an opinion on the branch's financial statements.

Review of the External Audit by the Examiner

The examination procedures section describes the steps to be followed by the examiner in conducting a review of the CPAs and the work they perform.

U.S. regulatory agencies have generally concluded that, in view of their objectives regarding the reliance to be placed on work performed by CPAs and in view of the professional and ethical standards of the public accounting professions, only in unusual situations should the examiner conduct an in-depth review of the competence and independence of the CPA or of the adequacy of the CPA's audit. One situation that the examiner should investigate would be a recent change in CPAs by the FBO, particularly if the change was made after an audit was commenced.

It ordinarily will not be necessary to make specific tests to determine independence. However, there may be occasions when the examiner may have sufficient reasons to question the independence of a CPA or the quality of his or her work. For example, the examiner may become aware that, during the period of a CPA's professional engagement, which includes the period covered by the financial statements on which the CPA has expressed an opinion, the CPA or a member of his or her firm—

- Had a direct financial interest in the FBO;
- Was connected with the FBO in a capacity equivalent to that of a member of management or was a director of the FBO;

- Maintained, completely or in part, the books and records of the FBO and did not perform audit tests with respect to such books and records; or
- Had a loan from the FBO (as discussed earlier).

In these and similar instances, the CPA would not have complied with professional standards.

The examiner should determine the scope of the CPA's audit or examination by reviewing the most recent report and management letter, if any, issued by the CPA. If the audit is in progress or will begin in the near future, the examiner should also review any engagement letter to the branch from the CPA. If available, the examiner also should obtain and review any adjusting journal entries suggested by the CPA at the conclusion of the examination. This procedures should be done to determine whether such entries were the result of breakdowns in the internal control structure and procedures for financial reporting.

Under certain circumstances, a CPA may issue a qualified or adverse opinion or may disclaim an opinion on a branch's financial statements. In such circumstances, the examiner should first determine the reasons for the particular type of opinion issued. If the matters involved affect specific areas of the branch's operations, a review of this work performed by the CPA may help the examiner understand the problem that gave rise to this opinion.

Communication Between External Auditors and Examiners

On July 23, 1992, the Federal Reserve and the other federal bank and thrift regulatory agencies (FDIC, OCC, and OTS) issued an interagency policy statement on coordination and communication between external auditors and examiners. The policy statement provides guidelines regarding information that should be provided by federally-insured depository institutions to their external auditors and meetings between external auditors and examiners in connection with safety and soundness examinations. While the policy statement focuses on insured depository institutions and their external auditors, bank holding companies and U.S. branches of foreign banks that are examined by the Federal Reserve are encouraged to provide similar information to

their external auditors and to make similar arrangements regarding auditor attendance at meetings with examiners.

Generally Accepted Auditing Standards (GAAS) require that the external auditor can consider regulatory authorities as a source of competent evidential matter when conducting an audit of the financial statements of a banking organization. Accordingly, the external auditor may review communications from and make inquiries of the regulatory authorities.

Generally, the U.S. regulatory agencies encourage auditors to attend examination exit conferences upon completion of the examiner's field work or other meetings concerning examination findings between supervisory examiners and a branch's management. Branches should ensure that their external auditors are informed in a timely manner of scheduled exit conferences and other relevant meetings with examiners and of the FRB's policies regarding auditor attendance at such meetings.

When other conferences between examiners and management are scheduled (those that do not involve examination findings that are relevant to the scope of the external auditor's work), the branch should first obtain the approval of the appropriate regulatory agency for the auditor to attend the meetings. The Interagency Policy Statement of July 23, 1992, does not preclude regulators from holding meetings with management without auditor attendance or from requiring that the auditor attend only certain portions of the meetings.

The interagency policy statement was issued to improve coordination and communication between external auditors and examiners. Examination personnel should provide branches with advance notice of the start date of the examination, when appropriate, so management can inform external auditors in advance and facilitate the planning and scheduling of their audit work.

Meetings and Discussions Between External Auditors and Examiners

An external auditor may request a meeting with regulatory authorities involved in the supervision of the branch, during or after completion of examinations, to inquire about supervisory matters relevant to the branch under audit. External auditors should provide an agenda in advance.

The regulatory authorities will generally request that management of the branch under audit be represented at the meeting. In this regard, examiners generally will only discuss with an auditor those examination findings that have been presented to bank management.

In certain cases, external auditors may wish to discuss with examiners matters relevant to the FBO, without bank management representation. External auditors may request such confidential meetings with the regulatory authorities and vice versa.

Information Required to be Made Available to External Auditors

Section 112 of FDICIA pertains to depository institutions insured by the FDIC that have engaged the services of an external auditor to audit the banking organization within the past two years. It requires insured branches to provide the auditor with copies of the most recent Report of Assets and Liabilities (call report) and report of examination and pertinent correspondence or reports received from a U.S. regulatory agency. This information is to be provided to the external auditor by the insured branch under audit, not by a regulatory agency.

In addition, insured branches must provide the independent auditor with:

- A copy of any supervisory memorandum of understanding or written agreement between a federal or state banking agency and the FBO or branch put into effect during the period covered by the audit.
- A report of any formal action initiated or taken by a federal or state banking agency during such period or any civil money penalty assessed with respect to the FBO or branch or any institution-affiliated party.

Regulatory personnel should ascertain if the banking organization is in compliance with the requirements of section 112 of FDICIA (12 USC 1831m(h)) and report instances of noncompliance in the Compliance section of the report of examination.

CONFIDENTIALITY OF SUPERVISORY INFORMATION

While the policies of regulatory authorities gen-

erally require that external auditors be given access to the information described above, institutions and their auditors are reminded that information contained in examination reports and supervisory discussions—including any summaries or quotations—is confidential supervisory information and must not be disclosed to any party without the written permission of the issuing agency. Unauthorized disclosure of confidential supervisory information may lead to civil or criminal actions, fines, and other penalties.

AUDIT PROGRAM OVERSIGHT

Because auditors' reporting lines may significantly affect the overall objectivity and thoroughness of the audit findings and conclusions, an analysis of their structure should be factored into the evaluation of the audit program's effectiveness. When internal and external auditors report solely to senior management of the branch, rather than head office management, their independence may be compromised. As a result, they will not, in all likelihood, maintain the same objectivity in evaluating the branch's operations. Auditors should certainly report relevant audit findings to branch management; however, organizational and official audit reporting lines should ensure auditors' independence and objectivity.

The independence of internal and external auditors is increased when they report to a separate audit officer, department, or committee not otherwise involved in the affairs of the branch. The auditors' independence is enhanced when some type of objective third party takes an active role in approving the internal and external audit scope and plan.

This independent party's duties may include overseeing the internal audit function, such as approving salary, hiring, and firing decisions relating to senior staff level positions; approving or recommending the appointment of external auditors and the scope of external audits and other services; providing the opportunity for auditors to meet and discuss findings apart from branch management; reviewing with management and external auditors the year-end financial statements; and meeting with regulatory authorities.

MANAGEMENT'S RESPONSE TO THE AUDITS

Head office management should require that branch management respond formally to audit findings and take appropriate corrective action. The audit process is not complete until the auditor is satisfied that audit findings have received appropriate attention. By requiring management to respond formally to audit findings, head office contributes to the effectiveness of the audit function and increases the likelihood that the findings will receive appropriate attention. Auditors should not be accountable for implementation of corrective action, which is the responsibility of branch and head office management. However, the audit program's structure should include means of (1) securing management's plans to address audit comments and (2) verifying these plan's effectiveness in correcting identified problems.

It is imperative that management respond to all internal and external audits and regulatory examinations. Management responses should be timely and address all findings in the reports, unless specifically noted in the audit report that a response is not necessary. Responses should include concrete solutions that have already been put in place or that will be implemented in a timely manner. Repeat problems noted in the audit report are to be given the highest priority.

Head office and branch senior management should receive copies of management's responses, along with copies of the audit reports. The audit staff and head office should follow-up on the responses given by management to ensure that all matters are properly and effectively resolved in a timely manner. The examiners must also follow up on management's responses to ensure that responses are fully implemented.

REGULATORY EXAMINATIONS

Home country regulators may examine their respective banks in the United States periodically. If these examinations occur, the examiner should find out the scope and frequency of the examinations and obtain a copy of any report, if available. If a copy of this regulatory report is available, the examiner should determine if there are any significant deficiencies or matters that have a bearing on the FBO's operations in the United States. As a matter of courtesy, the home country regulators should contact the U.S. bank supervisors before any on-site examinations and agree to meet with them before and after the conclusion of their examinations to share the scope and results of such visitations.

Internal and External Audits Examination Objectives

Effective date July 1997

Section 4010.2

- To determine whether internal and external audit or regulatory examination functions exist and are consistent with the institution's size, complexity of operations, level of growth, and nature of weaknesses.
- To evaluate the independence and competence of those who carry out the internal and external audit function.
- To determine the adequacy of the procedures performed by the internal and external auditors.
- To determine the adequacy of the frequency and scope of the audit program, which should include testing for compliance with applicable U.S. statutory and regulatory requirements.
- To determine based upon the above criteria whether the work performed by internal and/or external auditors is reliable.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Internal and External Audits Examination Procedures

Effective date July 1997

Section 4010.3

Some of these procedures will not be applicable to every branch, particularly at branches that do not have internal auditors on site.

Before reviewing any specific audit procedures, the examiner should first determine the independence and competence of the internal auditors. If the examiner believes the auditors are both independent and competent, he or she should then determine the acceptability of their work. Based on the answers to the audit function questions and on the auditors' work, the examiner must then determine the scope of the examination. At a minimum, the examiner should review the scope and frequency of the audit program and the results of the most recent audit.

The program and related supporting documentation should be completed in an organized manner and should be retained as part of the examination workpapers.

Upon completion of the program, the examiner should be able to formulate a conclusion on the adequacy of audit coverage. Conclusions involving weaknesses in the internal audit work being performed at the branch should be summarized for the report of examination. Significant recommendations should be discussed with branch management and noted in the questionnaire and in the report of examination. If recommendations are made verbally, a memorandum of the discussion with management should be prepared and included in the workpapers.

- Determine whether the branch utilizes a system of self checks in lieu of a formal audit program. If so, determine the adequacy of this system and assess whether proper procedures are in place to ensure its independence from those responsible for implementing the system.
- 2. Independence of the Audit Function—Assess the independence of the internal auditor by reviewing the reporting lines within the organization and to whom or at what level audit results are reported. Interview the internal audit department manager and observe the operation of the audit department to determine its functional responsibilities and reporting lines. Interviews during the examination may not be practical if auditors are based in the home country or at another U.S.

- branch. If auditors are based at the head office, the examining agency may wish to arrange a meeting with the auditors when they visit the United States.
- 3. Auditors' and Audit Staff Qualifications— Review the biographical data of and interview the internal audit department manager, to determine his or her ability to manage the internal audit department. Review the biographical data of the audit department staff to determine their qualifications for their delegated responsibilities.
- 4. Content and Utilization of the Audit Scope and Frequency Schedule—Review the audit schedule and ascertain that all high risk areas have adequate and timely coverage. Obtain input from members of the examination team who are reviewing individual areas to determine additional high risk areas. Determine whether the audit department's program is annually reviewed and approved by head office.
- Documentation of the work performed— Review the audit work programs to ascertain that the work programs satisfy the audit objectives and indicate the procedures performed, the extent of testing, and the basis for the conclusions reached.
- Audit Department's Formal Reporting Procedures
 - a. Review the audit reports issued since the previous examination for:
 - the auditor's opinion on the adequacy, effectiveness, and efficiency of the systems of control and quality of ongoing operations;
 - the timeliness with which the findings were reported;
 - the identification of the areas audited;
 and
 - the disclosure of all matters that require attention.
 - Ascertain that the distribution of the audit report followed the required reporting lines
 - c. Ascertain that a written response to the report was provided by the recipient in a timely manner and that it addressed the matters requiring attention.
 - d. Review the audit department's follow-up procedures for adequacy.

- 7. If CPAs and/or consulting firms have been engaged by the FBO for statement certifica-tion, branch reviews, or appraisal of the audit function, review the most recent reports and/or management letters to become aware
- of any important accounting or control problems.
- 8. If possible, review the most recent home country regulatory examination report.

Internal and External Audits Audit Function Questionnaire

Effective date July 1997

Section 4010.4

Review the documentation, as instructed in the examination procedures, in order to answer the following audit function questions. Where appropriate, supporting documentation and pertinent information should be retained or noted under comments.

ORGANIZATIONAL STRUCTURE OF THE AUDIT DEPARTMENT

- 1. Has the head office delegated responsibility for the audit function? If so, to whom?
- 2. Does the auditor report independently to the head office or a party with objective oversight of the audit function? Describe.
- 3. If not, to whom does the auditor directly report? Do these reporting lines jeopardize the independence of the audit function?
- 4. Are those in charge of the audit function qualified for their particular responsibilities?
- 5. Do individuals charged with audit oversight meet with and review reports issued by the auditor independent of branch personnel? If so, how often?
- 6. Do the minutes of any meetings of audit oversight groups indicate an appropriate interest in auditors' activities and findings?

INDEPENDENCE OF THE AUDIT FUNCTION

- 7. Is the audit department functionally segregated from operations in the organizational structure?
- Are the budget, performance, salary, and other benefits of the auditor established, reviewed, and/or approved independent of the branch? If not, describe.
- 9. Are the reporting procedures of the auditor independent of the influence of any personnel whose duties or responsibilities are covered in the audit's scope?
- 10. Do the responsibilities of the audit staff include any duties or back-up duties that compromise dual controls, e.g., preparation or approval of general ledger entries, official checks, daily reconcilements, etc.?

AUDITOR'S QUALIFICATIONS

- 11. Are the auditor's academic credentials comparable to other branch officers having major responsibilities within the organization?
- 12. Is he/she certified (or in the process of becoming certified) as a Chartered Bank Auditor, Certified Internal Auditor, or Certified Public Accountant (CPA)? Does the auditor hold any other type of foreign country professional designation? If yes, which one(s)?
- 13. Does he/she communicate and relate well with all levels of personnel?
- 14. Does the auditor demonstrate a commitment to continuing education and a current knowledge of the latest developments in banking and auditing technology?

AUDIT STAFF QUALIFICATIONS

The following questions need to be addressed if there is an audit staff on site at the branch:

- 15. Is the audit staff sufficient in number to perform its tasks in a timely and complete manner?
- 16. Is the staff adequately experienced in auditing and banking? What are the educational backgrounds of the staff?
- 17. Are members of the staff experienced in any specialized activities conducted by the branch, e.g., EDP, foreign exchange trading, trust, etc.?
- 18. Is there a formal audit training program in effect?
- 19. If needed, does management have plans to improve its audit capability?

CONTENT AND UTILIZATION OF THE AUDIT FREQUENCY AND SCOPE SCHEDULE

20. Does the auditor perform a risk assessment? If not, how are the scope and frequency of audits determined? Is the resulting audit program formalized and on record as a commitment that can be analyzed and reviewed?

- 21. Are all important branch functions and services included in the audit scope?
- 22. Does the audit program include procedures necessary to reasonably ensure compliance with applicable U.S. laws and regulations, including the Bank Secrecy Act?
- 23. Does the internal audit department have access to all reports, records, and minutes?
- 24. Is the program periodically reviewed, where necessary, to adapt it to changing conditions?
- 25. Does the frequency and scope schedule require approval by a party with objective audit oversight? If so, by whom and has such approval been obtained?
- 26. Does the auditor periodically report his/her progress in completing the frequency and scope schedule to a party with objective audit oversight?
- 27. Do audit procedures ensure that items on the audit scope are looked at with sufficient detail to ensure adequate review?
- 28. Are controls on opening and closing general ledger and subsidiary accounts adequate and is the auditor formally advised of any changes?
- 29. If the branch has automated systems, does the program call for the application of independently prepared computer programs that employ the computer as an audit tool for surveillance and/or possible off-site testing?
- 30. Are all service-related activities not specifically manifested in general ledgers accounts subject to adequate periodic review, e.g., supervisory regulations, security, vacation policy, purchases, travelers checks, and safekeeping?

AUDIT DEPARTMENT PARTICIPATION IN REVIEWING SYSTEMS DESIGN PROJECTS AND MAJOR OPERATIONAL PROCEDURE CHANGES OR MODIFICATIONS

The following questions will be addressed by IS examiners:

31. Is there a formal or informal procedure for notifying the auditor of contemplated new systems or systems modifications in the early planning stages?

- 32. Is the auditor a member of an executive systems planning or steering committee? If not, does the auditor have access to and review the minutes of such committees?
- 33. Does an audit representative review the activities of systems design teams for audit and internal control requirements? Is the specialized training and experience of the audit staff sufficient to support effective reviews?
- 34. Does the audit department avoid overparticipation in systems design, modification, and conversion?
- 35. Is the auditor's "sign-off" on new or modified systems restricted to control and audit trail features?

AUDIT DEPARTMENT'S FORMAL REPORTING PROCEDURES

- 36. Does the auditor submit formal reports? If so, to whom?
- 37. Do the reports convey to the reader the auditor's general observation of the condition of the operation of the department or function?
 - a. Do they adequately reflect the scope of the audit?
 - b. Do they contain an opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
 - c. Do they call for a prompt response, where appropriate?
- 38. Are exceptions and recommendations resolved and implemented on a timely basis?
- 39. Are audit reports submitted promptly?
- 40. Does branch management respond to all internal and external audits?
 - a. Are management's responses completed promptly? Are they written?
 - b. Does the head office or branch senior management receive copies of management's responses?

EXTENT TO WHICH AUDIT COMPUTER PROGRAMS ARE USED AND THEIR EFFECTIVENESS

The following questions are to be addressed if audit computer programs are used:

- 41. What audit computer programs are used and what are their purposes?
- 42. Is any member of the audit staff qualified to write and/or appraise the quality of audit computer programs?
- 43. Is the auditor satisfied that he/she has sufficient "free access" to the computer files?
- 44. Are audit programs run on the auditor's request?
 - a. If operators run audit programs, are they supervised by the auditor?
 - b. If not, how are they controlled?
- 45. Do direct verification programs allow the auditor flexibility in selecting the criteria to be used in determining the sample?
- 46. Have procedures been established for the development and maintenance of documentation for audit computer programs? Are they adhered to?
- 47. Are changes to audit programs controlled?

EXTERNAL AUDIT ACTIVITIES

The following questions are to be addressed if an external audit has been performed:

- 48. Where state or federal regulations or stock exchange listing require an independent CPA audit, did the branch comply?
 - a. Was an opinion rendered by the accounting firm and if so, was it unqualified?
 - b. If the opinion was qualified, has the auditor taken appropriate action in the resolution of any deficiencies?
- 49. Does the FBO's policy prohibit loans to its external auditor or the engagement of an external auditor who is a shareholder? If not, has head office considered the materiality of any existing transactions regarding the auditor's independence?
- 50. Has an external auditor been engaged to perform special reviews of specific departments or areas of the branch since the previous examination? If deficiencies were cited, have they been corrected?

- 51. Has the same public accounting firm been engaged for the prior two years? If not, obtain a reason for change.
- 52. Have management letters from the external auditors or other reports from consultants been presented to management since the last examination?
- 53. Do deficiencies in management letters receive appropriate attention?
- 54. Are the notes pertaining to the financial statements reviewed for any information that may allude to significant accounting or control problems?
- 55. Does the report of examination and/or the management letter submitted by the public accounting firm comprehensively define the scope of the examination conducted?
- 56. Do the external auditors receive a copy of the most recent statutory and/or regulatory examination report(s) and reports of assets and liabilities, as may be required or appropriate? Do they receive copies of pertinent correspondence, including supervisory letters and management's responses, if any, between the branch and the examining authority?

HOME COUNTRY REGULATORY EXAMINATION ACTIVITIES

- 57. Do home country regulators periodically examine the branch in the United States? If so, do they produce a report? If yes, then the following questions will be addressed.
- 58. Does the branch's internal auditor have access to examination reports produced by the home country regulators?
- 59. Does the branch investigate the reasons for adverse comments and recommendations in the examination reports?

Internal and External Audits Audit Guidelines

Effective date July 1997

Section 4010 5

AUDIT MANUAL

- 1. Has responsibility for the establishment and maintenance of the audit manual been clearly assigned?
- 2. Does the audit manual require approval by the head office, the audit committee, or others? If so, has such approval been obtained?
- 3. Is the content of the audit manual independent of adverse influence of other interests, such as operating management or independent CPAs?
- 4. Is the audit manual current and are procedures for keeping the manual current adequate?
- 5. Does the audit manual contain the scope and objective of each audit?
- 6. Does it require that valid deviations from audit procedures be officially approved by audit management?
- 7. Do audit procedures provide for the follow-up of exceptions noted in previous audits?
- 8. Does it prescribe that each audit procedure be cross-referenced to the appropriate audit workpapers?
- 9. Must an auditor initial each program step as testimony of his/her performance?
- 10. Does it prescribe that full control be established at the time of entry over the records selected for audit?
- 11. Is proof of control records required?
- 12. Are direct verification programs covering all forms of customer deposit, loan, safe-keeping, collateral, collection, and trust accounts included?
- 13. Are flow charts called for as evidence of thorough analytical auditing?
- 14. Do the procedures employ scientific sampling techniques with acceptable reliability and precision?
- 15. Does the audit manual provide for the resolution of exceptions and deficiencies?
- 16. Does the audit manual contain provisions for report format and content and an expression of the opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
- 17. For each audit, do audit procedures provide a documented method of assuring audit management that a proper study and evalu-

- ation of existing internal controls has been made, such as through the use of an internal control questionnaire or memorandum?
- 18. Does the audit manual include a provision for a review and update of the procedures for each audit, where required, upon its completion?
- 19. Does the audit manual make provision for the maintenance of a permanent file for audits conducted?
- 20. Does the audit manual contain provisions for the formal, standardized preparation and maintenance of workpapers?
- 21. Are applicable statutory and regulatory requirements included in the audit procedures?

MAINTENANCE OF AUDIT RECORDS

- 22. Are workpapers arranged and maintained in two groups for filing and reference in:
 - a. The current file?
 - b. The permanent file?
- 23. Is a reasonable retention schedule and departmental index maintained for audit records?
- 24. Are audit procedures complied with during each audit?
- 25. Do the workpapers contain evidence of all significant deviations from audit procedures with the approval of audit management?
- 26. Are procedures for preparing and maintaining workpapers adhered to?
- 27. Do workpapers contain a copy of the audit report, an adequate index, an internal control questionnaire, audit procedures, and other appropriate material?
- 28. Are workpapers numbered, indexed, and cross referenced to audit procedures and the workpaper index?
- 29. Is each workpaper dated and initialed by the preparer? Are sources of data clearly shown? Are tick marks explained?
- 30. From the workpapers, can it be determined how various sample sizes were determined, judgment or scientific, including range and confidence level?

- 31. Do workpapers show that supervisory personnel of the audit department have reviewed the workpapers and resultant findings?
- 32. Are all significant and/or unresolved exceptions noted in workpapers required to be included in the report?
- 33. Is the branch in compliance with applicable statutory and/or regulatory requirements?

Effective date July 1997

U.S. branches of foreign banking organizations are expected to have a fully effective system of internal controls similar to those required of U.S. banks. Although internal controls should provide for an internal audit program (which is separately covered in Section 4010 of this manual), this section applies to the review and evaluation of a branch's existing internal control environment. An examiner should review the internal audit program in conjunction with the review of internal controls in order to fully understand the branch's internal control system. The concept of operational efficiency and the related control procedures are not addressed in this manual because such considerations generally fall outside the responsibilities of an examiner. That, however, is not intended to inhibit or prevent an examiner from commenting on operational inefficiencies, particularly in instances where inefficiencies have a significant impact on the condition or risk standing of a branch.

INTERNAL CONTROL STRUCTURE

The internal control structure consists of the policies and procedures established to provide reasonable assurance that specific objectives will be achieved. The Statement on Auditing Standards No. 55, "Consideration of the Internal Control Structure in a Financial Statement Audit" (effective January 1, 1990), describes the three elements of an internal control structure. These elements are: the control environment, the accounting system, and control procedures. The elements, as described below, need to be considered in the review and evaluation of a branch's internal control system.\(^1\)

The *control environment* reflects the overall attitude, awareness, and actions of branch and head office management regarding the importance of control and its emphasis. The control environment includes the following:

· Management's philosophy and operating style.

- The branch's organizational structure.
- The functioning of committees
- Methods of assigning authority and responsibility.
- Management's control methods for monitoring and following up on performance, including internal auditing.
- · Personnel policies and practices.
- Various external influences that affect a branch's operations and practices, such as examinations by bank regulatory agencies.

The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report a branch's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will:

- Identify and record all valid transactions.
- Describe, on a timely basis, the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Properly present the transactions and related disclosures in the financial statements.

Control procedures are those policies and procedures, in addition to the control environment and accounting system, that management has established to provide reasonable assurance that specific branch objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Control procedures should include:

- Authorization of transactions and activities— Transactions and activities should be approved by appropriate management.
- Segregation of duties—By assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets, the chance of any

^{1.} The description of the three elements of an internal control structure was taken from the "Codification of Statements on Auditing Standards" published by the American Institute of Certified Public Accountants, 1990 (Source: Statement on Auditing Standards No. 55).

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person being in a position to both perpetrate and conceal errors or irregularities in the normal course of his/her duties, is reduced.

- Dual controls—Requiring two different people to perform one sensitive task, such as opening the vault or signing checks, also reduces the risk of defalcation. When two individuals must act in collusion to conduct fraud or defalcation, it is much less likely to occur.
- Job descriptions—In all departments, job descriptions should be well-defined and provide for logical flow of work. If employees have responsibilities for other offices or affiliates of the FBO, particularly those that share facilities with the branch, these responsibilities should be clearly defined and, when appropriate, disclosed or made clear to branch customers and the public in general.
- Policies—Policies regarding hiring practices, annual salary reviews, merit increases, performance evaluations, promotions, and vacations should be established and clearly understood. Adequate procedures should be in place to ensure that screening procedures are applied to personnel hired for sensitive positions. Any doubts about an individual's qualifications should be resolved before an employee is hired.
- Consecutive absence—Branch policy should require employees in sensitive positions to be absent from their duties for a minimum number of days. Prudent banking practice dictates that employees in sensitive positions be absent for ten consecutive days. In some instances, absence due to a business trip may be acceptable; however, it is necessary for someone else to perform the employee's duties for that period of time. In establishing the policy, branches should follow any applicable laws, regulations, or guidelines of their licensing or insuring authority(ies).
- Documents and records—Adequate documents and records should be used to ensure the proper recording of transactions and events, such as monitoring the use of pre-numbered shipping documents.
- Accessibility safeguards—Adequate safeguards over access to and use of assets and records, such as computer programs and data files, should be in place.
- Reconciliations—Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed con-

trols, management review of reports that summarize the detail of account balances, and user review of computer-generated reports should be conducted.

The applicability and importance of specific control environment factors, accounting methods and records, and control procedures that a branch establishes should be considered in the context of:

- The branch's size.
- · Its organization characteristics.
- The nature of its business.
- The diversity and complexity of its operations.
- · Its methods of processing data.
- Its applicable legal and regulatory requirements.

Establishing and maintaining an internal control structure is an important management responsibility. To provide reasonable assurance that a branch's objectives will be achieved, the internal control structure should be under ongoing supervision by management to determine that it is operating as intended and that it is modified, as appropriate, for changes in conditions

INTERNAL CONTROL OBJECTIVES

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

Existence of Procedures—The existence of prescribed internal control procedures is necessary but not sufficient for effective internal control. Prescribed procedures that are not actually performed do nothing to establish control. Consequently, the examiner must give thoughtful attention not only to the prescribed set of procedures but also to the practices actually followed. This step can be accomplished through

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inquiry, observation, testing, or a combination thereof.

Competent Performance—For internal control to be effective, the required procedures must be performed by competent persons. Evaluation of competence undoubtedly requires some degree of subjective judgment because attributes, such as intelligence, knowledge, and attitude are relevant. Thus, the examiner should be alert for indications that employees have failed so substantially to perform their duties that a serious question is raised concerning their abilities.

Independent Performance—Employees who have access to branch assets should not also (a) have access to the related accounting records, (b) perform related review operations, or (c) immediately supervise the activities of other employees who maintain the records or perform the review operations. Otherwise, such employees may be able both to perpetrate and conceal defalcations. Therefore, duties concerned with the custody of assets are incompatible with recordkeeping duties for those assets, and duties concerned with the performance of activities are incompatible with the authorization or review of those activities. In judging the independence of a person, the examiner must avoid looking at that person as an individual and presuming the way in which he or she would respond in a given situation. For example, an individual may be the sole check signer and an assistant may prepare monthly branch reconcilement. If the assistant appears to be a competent person, it may seem that an independent reconcilement would be performed and anything amiss would be reported. Such judgments are potentially erroneous. No established tests exist by which the psychological and economic independence of an individual in a given situation can be judged. The position must be evaluated, not the person. If the position in which the person acts is not an independent one, in itself, then the work should not be presumed to be independent, regardless of the apparent competence of the person in question. In the example cited above, the function performed by the assistant should be viewed as if it were performed by the supervisor. Hence, incompatible duties are present in that situation.

EXAMINATION PROCEDURES

An effective way to begin an on-site review of

internal controls is to identify the various key functions applicable to the area under review. For each position identified, the following questions should be asked:

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

Although all employees within a branch may be subject to control, not all have financial responsibilities that can influence the accuracy of the accounting and financial records or have access to assets. It is those positions, with the ability to influence the records and with access to assets, with which the examiner is primarily concerned. Once those positions have been identified, the examiners must exercise their professional knowledge of branch operations to conceive of any possibilities open to a person holding a particular position. The question is not whether the individual is honest but whether situations exist that might permit an error to be concealed. By directing attention to such situations, an examiner will also consider situations that may permit unintentional errors to remain undetected.

When reviewing internal controls, an essential part of the examination is alertness to indications that adverse circumstances may exist. Adverse circumstances may lead employees or officers into courses of action they normally would not pursue. An adverse circumstance to which the examiner should be especially alert is when the personal financial interests of key officers or employees depend directly on operating results or financial condition. Although the review of internal control does not place the examiner in the role of an investigator or detective, an alert attitude toward possible conflicts of interest should be maintained throughout the examination. Branches staffed by members of the same family, branches completely dominated by a strong personality, or departments in 4020.1 Internal Control

which supervisors rely unduly on their assistants require special alertness on the part of the examiner. These and other similar circumstances should be considered in preparing the questionnaire. It is not the formality of the particular factor that is of importance but rather its effect on the overall operation under review. When circumstances that may affect answers to the basic questions exist, a notation of the circumstances should be made along with conclusions concerning their impact on the examination.

The examiner should also be alert for deviations from established policies, practices, and procedures by branch personnel. Examples of such deviations include situations when instructions and directives are not revised to reflect current practices, employees find short cuts for performing their tasks, changes in organization and activities that may influence operating procedures in unexpected ways, and employees duties are rotated in ways that have not been previously considered. These and other circumstances may serve to modify or otherwise change prescribed procedures giving the examiner an inadequate basis for evaluating internal control.

Furthermore, the examiner should consider other existing accounting and administrative controls or other circumstances that might counteract or mitigate an apparent weakness or impair an established control. Controls that mitigate an apparent weakness may be a formal

part of the branch's operating system, such as budget procedures that include a careful comparison of budgeted and actual amounts by competent management personnel. Mitigating controls also may be informal. For example, in small branches, management may be sufficiently involved in daily operations to know the purpose and reasonableness of all expense disbursements. That knowledge, coupled with the responsibility for signing checks, may make irregularities by non-managers unlikely, even if disbursements are otherwise under the control of only one person.

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

Internal Control Examination Objectives

Effective date July 1997

Section 4020.2

- To determine the adequacy of the internal control structure (i.e. the control environment, accounting system, and control procedures) in relation to the branch's size and complexity.
- To determine the level of adherence to procedures and systems.
- 3. To evaluate whether the system of controls is regularly reviewed to keep pace with changes
- in the branch's business or strategic plan as well as laws and regulations.
- To recommend corrective action when internal control policies, practices, or procedures are deficient or when violations of laws or regulations have been noted.

Internal Control Examination Procedures

Effective date July 1997

Section 4020.3

- Using methods such as reviewing completed examiner workprograms and accompanying workpapers, directly observing and discussing policies and procedures with branch personnel, and testing when appropriate, determine the following:
 - a. The adequacy of policies and any deviations from established policies, practices, and procedures by branch personnel (including personnel policies);
 - The effectiveness of the accounting system to:
 - · identify and record transactions; and,
 - provide sufficient detail to properly classify, value, and record the date of transactions for financial reporting;
 - c. The adequacy of internal control procedures given the type and level of risks posed by the size and complexity of the branch:
 - d. The lines of authority and responsibility for reviewing, approving, and monitoring adherence to policies and procedures;
 - e. The existence of adequate job descriptions for all employees;
 - f. The competence of persons performing the required procedures;
 - g. The separation of duties of persons who have access to branch assets;

- Any indications of adverse circumstances or conflicts of interest surrounding employees or officers which could lead them into courses of action they would normally not pursue;
- Any internal control deficiencies or violations of law noted; and
- j. Any other comments regarding the adequacy of internal controls.
- Discuss findings with senior management of the branch. During the discussion, elicit management's responses for corrections of deficiencies and/or violations.
- Write, in appropriate report format, general remarks regarding internal control that may include:
 - a. The quality of internal control policies, practices, and procedures;
 - The lines of authority and responsibility for reviewing, approving, and monitoring adherence to policies and procedures;
 - c. The general adherence to internal control policies, practices, and procedures;
 - d. The competency and independence of personnel performing the internal control procedures; and,
 - e. Any deficiencies and violations noted.

Effective date July 1997

The purpose of an emergency preparedness plan is to identify the actions to be taken to minimize financial business loss in the event of a disaster. All financial institutions, including a branch, are expected to have an emergency preparedness plan, which has been approved by senior management at the branch and/or appropriate management levels at its head office. When a branch experiences an emergency or disaster situation in the United States, the assistance the head office can provide may be limited due to geographic distance and differences in time zones. Therefore, a branch must be self-sufficient and have adequate contingency plans in place to restore operations. The emergency preparedness plan ("plan") should contain pre- and postemergency operations procedures, and the actions required during the emergency. The procedures should be tested and the results documented. The plan should address the continuity of management, the reconstruction of essential records, an alternate operating headquarters, and the protection of personnel. In addition, the plan should give a time table for reconstruction of the critical operations.

CONTINUITY OF MANAGEMENT

Continuity of management is critical to the decision-making process during an emergency and, therefore, should be documented in the plan, along with necessary telephone numbers. The emergency preparedness plan should also ensure that an officer is available in a post-emergency situation to take official action.

RECONSTRUCTION OF ESSENTIAL RECORDS

Contingency plans should address the restoration of electronic data processing (EDP) facilities and the restoration of other areas within the branch, including communications, electronic funds transfer, signature cards and customer records, documentary evidence of credit extensions, contingent liabilities, and funds placement. The plan should indicate how the required records will be restored or recovered, where the appropriate support from outside vendors will be obtained, and how much manpower will be needed to restore operations. Written agreements with outside vendors should be in force and copies readily accessible.

ALTERNATE OPERATING HEADQUARTERS

An alternate operating site should be designated in a different city or vicinity from the branch. In selecting an alternate operating site, consideration should be given to having a separate power grid, different water main, and central telephone stations from the branch. The optimal alternate site could be another banking site of the FBO, located in a different state, which would be able to provide EDP and communications support. The alternate site should be remote enough so that it can be used in the event of a local disaster (i.e., fire, flood, earthquake, hurricanes, civil disturbance, etc.). In the event this type of alternate site is not available, or is prohibitively expensive, the emergency preparedness plan should have in-depth and well-thought out procedures to restore branch operations at another location in a timely manner.

PROTECTION OF PERSONNEL

Because most branches do not own their premises, security and shelter protection for personnel is partially dependent on the owner of the premises. Building evacuation and emergency operation procedures should be detailed in the branch's plan and be readily accessible to all personnel. Training in panic control, evacuation procedures, and self-protection should be given to branch personnel at least annually.

Emergency Preparedness Measures Examination Objectives

Effective date July 1997

Section 4030.2

- To determine if the emergency preparedness policies, practices, procedures, and internal controls are adequate.
- To determine if branch officers are operating in conformance with the established guidelines from head office.
- 3. To determine whether the level of training among branch officers and employees is
- adequate for them to properly perform their emergency responsibilities.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Emergency Preparedness Measures Examination Procedures

Effective date July 1997

Section 4030.3

- Obtain the branch's emergency preparedness program and determine whether it addresses the following:
 - a. Continuity of Management
 - Succession plans for senior officers and administrative personnel;
 - The designation of a senior level officer responsible for re-opening the branch;
 - The informing of designated substitute personnel of their duties under the plan.
 - b. Record and Asset Protection and Reconstruction
 - The duplication and remote storage of essential records;
 - The remote storage of important PC applications;
 - Procedures for the reconstruction or recovery of records and post-emergency procedures, and the testing of these procedures:
 - c. Alternate Location
 - The designation of an alternate location which is sufficiently removed from the main site and written agreements for the use of the alternate site;
 - The notification of the alternate site to customers and third party contractors in the instances when the alternate site is used:
 - Plans for emergency operations at its alternate location, and the testing of such plans;
 - The maintenance of copies of these plans at each site, and the requirement that all officers have copies;
 - Plans for personnel assembly at the alternate site or at rendezvous points;
 - Senior level management monitoring of conditions at the alternate site and reporting back regularly to head office and local regulatory authorities.
 - d. Personnel Protection
 - Group employee training regarding operation of the emergency preparedness plan, panic control, evacuation pro-

- cedures, and self-protection, and the documentation of such training;
- Distribution of the plan to appropriate employees.

e. Other

- The designation of an emergency/security officer.
- The notification of head office and local regulatory authorities of actions taken during an emergency.
- Determine if the branch's contingency program has been approved by appropriate management levels at the head office, and how frequently the program is reviewed.
- Determine the type of training branch personnel receive for emergency situations and assess their knowledge of their responsibilities in the event of an emergency.
- Determine how frequently the branch tests its emergency preparedness program, and how deficiencies are tracked after tests are completed.
- 5. Determine if the branch has designated an emergency/security officer.
- Determine if resolutions have been adopted by head office to enable available or surviving branch officers to take official action.
- Determine if copies of these resolutions and the emergency preparedness plan have been stored off-site for safekeeping and are readily accessible.
- Determine if, in the case of an emergency, the re-opening team will receive regular updates from local authorities as to when the original premises can be accessed.
- 9. Determine if there are arrangements to notify head office, the regulatory authorities, customers and vendors of the re-opening of the original premises when it occurs.

Effective date July 1997

Cash accounts include U.S. and foreign coin and currency on hand and in transit, clearings, and cash items.

CASH

Most branches maintain a certain amount of U.S. currency and some may have foreign currency on hand. Each branch should establish policies and procedures appropriate for the level of cash maintained at the branch.

CLEARINGS

Clearings are checks, drafts, notes, and other items that a branch has cashed or received for deposit that are drawn on other local banks and are cleared directly with them. Such items usually can be exchanged more efficiently among local banks, than through correspondent banks or the Federal Reserve System. Some branches also provide clearing services for other foreign banks, including central banks.

CASH ITEMS

Cash items are checks or other items in the process of collection that are payable in cash

upon presentation. A separate control of all such items usually is maintained on the branch's general ledger and is supported by a subsidiary record of individual amounts and other pertinent data.

In addition to those items carried in the separate account entitled cash items on the general ledger, some branches will have several sources of internal float, in which irregular cash items can be concealed. Such items include any memoranda slips; checks returned by other banks; checks of officers, employees, and their interests; checks of affiliates; debits purporting to represent currency or coin shipments; notes, usually past-due; and all aged and unusual items of any nature that might involve fictitious entries, manipulations or uncollectible accounts.

If the cash items are not in the process of collection, they should be included on the branch's books in an appropriate account and shown under other assets. These are items that are payable upon presentation but which the branch has elected to accumulate for forwarding to the payor on a periodic basis. If the items are not immediately payable in cash upon presentation or if they were not paid when presented and, after a predetermined period of time, require further collection effort, they also should be included in a noncash asset account, such as cash items not in process of collection and shown under other assets.

Cash Accounts Examination Objectives

Effective date July 1997

Section 4040.2

The following should be undertaken only if warranted by significant cash volume or activity.

- To determine if the policies, practices, and procedures and internal controls regarding cash accounts are adequate.
- To determine if officers and employees are operating in conformance with established guidelines.
- 3. To determine the scope and adequacy of the internal and external audit function.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Cash Accounts

Examination Procedures

Effective date July 1997

Section 4040.3

The purpose of this section is to determine whether the branch has established appropriate policies and procedures to ensure compliance with the regulations and provide for an effective internal control environment.

This section will not be applicable to branches that do not maintain cash on premises.

- Based on the evaluation of internal controls and any applicable comments by internal and external auditors, determine the scope of the examination.
- If included in the scope of the examination, complete or update the Cash Accounts section of the Internal Control Questionnaire.
- 3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the most recent review by internal or external auditors and determine if appropriate corrections have been made.
- 4. Obtain a detailed listing of all cash items, including any bank items that are carried in the general ledger under other assets. Verify listings to general ledger balances and scan for propriety and conformity to branch policy.
- Determine, by discreet corroborative inquiry of responsible branch officials and review of

- documentation, whether defalcations and/or mysterious disappearances of cash since the preceding examination have occurred. If so, have they been properly reported, pursuant to current requirements of the applicable bank supervisory agencies?
- 6. Review foreign currency control ledgers and dollar book value equivalents for:
 - a. Accuracy of calculations and booking procedures.
 - b. Unusual fluctuations.
 - c. Concentrations.
 - d. Unusual items.
- 7. In keeping with the scope of the examination, review compliance with the Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act, 31 CFR 103. Examination policies and procedures in this regard may be found in the Federal Reserve's Bank Secrecy Act Manual and other similar examination material prepared by the other federal and state banking agencies.
- Prepare comments on deficiencies or violations of law or regulations noted above for inclusion in the examination report.
- Prepare a complete set of workpapers to support conclusions reached. Include any information that will facilitate future examinations.

Cash Accounts

Internal Control Questionnaire

Effective date July 1997

Section 4040.4

Review the branch's internal controls, policies, practices, and procedures for cash accounts. The system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

- 1. Regarding vault control:
 - a. Is a register maintained that is signed by the individuals opening and closing the vault?
 - b. Is the vault under dual control?
 - c. Are combinations changed periodically and every time there is a change in custodianship?
- 2. Does an officer or other designated individual review the disposition of all cash items over a specified dollar limit?
- 3. Does the branch have an adequate chargeoff policy for uncollected cash items?
- 4. Do the branch's present procedures forbid the holding of overdraft checks in the cash item account?
- 5. Are all cash items reviewed at least monthly at an appropriate level of management?
- 6. Are cash items recommended for charge off, reviewed, and approved by a branch officer with no operational responsibilities?
- 7. Are returned items:
 - a. Handled by an independent section of the department or delivered unopened to personnel not responsible for preparing cash letters or handling cash?
 - b. Reviewed periodically by responsible supervisory personnel to determine that items are being handled correctly by this section and are clearing on a timely basis?

- c. Scrutinized for employee items?
- d. Reviewed for large or repeat items?
- 8. Are holdover items:
 - a. Appropriately identified in the general ledger?
 - b. Handled by an independent section of the department?
 - c. Reviewed periodically by responsible supervisory personnel to determine that items are clearing on a timely basis?
- 9. Are foreign currency control ledgers and dollar book value equivalents posted accurately?
- 10. Is each foreign currency revalued at least monthly and are profit and loss entries passed to the appropriate income accounts?
- 11. Are revaluation calculations, including the rates used, periodically reviewed for accuracy by someone other than the foreign currency tellers?
- 12. Does the internal or external auditor periodically review revaluation calculations, including the verification of rates used and the resulting general ledger entries?

CONCLUSION

- 13. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 14. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

CASH

- Immediately upon arrival, determine the location of all cash and cash items to be controlled.
- 2. Establish control over all necessary items (consider the use of seals) and, using appropriate sampling techniques, select funds to be counted and assign personnel to the various funds. There should be no movement of cash or securities in to or out of the vault area unless such movement is controlled by an examiner. All compartments in the vault should be sealed (including lockers reported to contain other than cash) until all items are counted and control is no longer necessary. (Note: Sealing of vaults containing other than cash is to be performed by examiners responsible for those areas.)
- 3. Inquire if the branch has incoming or outgoing cash shipments and confirm such amounts. If bagged items are on hand, note contents without counting and control bags to armored car pick-up, etc., and confirm balances with the recipient on a test basis. This step applies to Payroll Cash, Change Fund Cash, Mutilated Money, Fed Shipments, etc. Examine on a test basis subsequent payments for bagged cash.
- Obtain a copy of the teller's proof sheets as
 of the close of business for the day of
 the examination, and retain them for the
 workpapers.
- 5. Count and verify cash (both U.S. currency and foreign currency) to the proof sheets. Count foreign currency in separate totals for each currency. If after-hours transactions have been conducted, the debit and credit totals must be included in the reconcilement between actual cash counted and the closing cash figure reflected on the teller's proof sheets. The custodian of the cash and the examiner must both remain with the cash until the verification procedure is completed.
- 6. Transcribe cash count information to a blank cash sheet and retain for the workpapers. Upon completion of the count, obtain the teller's signature on the workpaper and release control over the fund. If a material

- difference is discovered by the examiner, the cash should be immediately recounted by the teller in the presence of the examiner. If the difference is not resolved, an officer should be called in to count the cash, and both the officer and the teller should be required to sign the cash sheet reflecting the actual amount of cash counted.
- Review all after-hours items to ensure their validity and trace the items to their final disposition.
- Detail all items on the cash sheet other than cash found in the cash compartments, even though they may not be required in the reconciliation process.
- Prepare a listing of proof sheets and verify or reconcile the total to the branch's daily statement and to the general ledger as of the examination date. (Note: The branch's daily cash form may be appropriate for this purpose.)
- 10. Review the teller's proof sheets for the day and ascertain that all balances are reasonable in relation to operating requirements and/or branch policy. Note any balances in excess of reasonable amounts in the workpapers for subsequent discussion with an appropriate branch official.
- 11. For each foreign currency held, verify approximate U.S. dollar carrying values by obtaining current bid bank note rates for the foreign currencies on hand. Using those rates, convert each foreign currency into U.S. dollar equivalents. The resulting U.S. dollar values should be verified with the amount shown on the branch's general ledger for reasonableness.
- 12. Check the accuracy of foreign currency revaluations and that resulting profit or losses are properly posted to appropriate income accounts. (Foreign cash may be revalued with other foreign currency ledger and future exchange contracts by the branch's accounting/auditing department.)

CASH ITEMS

- 13. Prepare lists of outstanding items.
- 14. Verify totals to the daily statement controls and to the general ledger.

- Using an appropriate sampling technique, select items for review of supporting documentation and request confirmation of payor.
- 16. Review all cash items selected to determine if they are legitimate, that they are being processed on a current basis, and that they contain no items from officers or employees.
- 17. Scrutinize any additional cash items that are not segregated in a control account to ensure their validity.
- 18. Investigate, through inquiry or other appropriate means, any unusual, stale, or recurring items and confirm their reasonableness or final disposition. All items not in the process of collection should be transferred to an appropriate noncash suspense account.
- Prepare a list of items recommended for charge off and ascertain that appropriate entries are made.
- 20. Release control of the cash items.

CLEARINGS

- Prepare a schedule of all clearings by bank name and cash letter total. Determine that the combined total agrees to the final recap and to the general ledger.
- 22. Select a number of individual clearing amounts for confirmation

- 23. Prepare and mail a positive confirmation request for each individual item selected. The receiving bank will balance the individual items to the cash letter total and will list any return items or other exceptions. During this process the auditor should be alert for unusual items, such as employee checks that have been deliberately misrouted.
- 24. Place confirmation requests in the related cash letters and maintain control over the cash letters until they are picked up for delivery.
- Cross-reference the control copies of the confirmations to the schedule noted in step 21.
- 26. Control all returned (answered) confirmations and investigate and resolve any reported differences. Include all confirmations in the workpapers and document the disposition of all exceptions.
- 27. Beginning on the audit date and for a period of 3 business days subsequent to the audit date, obtain all incoming returned items. Review the items and investigate any old or unusual items. Ascertain whether any items relate to officers or employees.

Consigned Items and Other Nonledger Control Accounts Effective date July 1997 Section 4050.1

Branches may provide a number of customer services, which normally do not result in assets and liabilities subject to entry on the general ledger. These customer services may include providing customer safekeeping, renting safe deposit boxes, selling travelers' checks, providing collection services, and providing custodian accounts. It is the branch's responsibility to properly maintain and safeguard all consigned items. Branches can ensure the necessary control and review of consigned items through the use of nonledger control or memorandum accounts. These nonledger control accounts consist of ledger cards for customer safekeeping and safe deposit box facilities, inventory listings for travelers' checks, registers for collection items, and registers for custodian accounts. It is essential that branch policy provides for proper internal controls, operating procedures, and safeguards. In all cases, control totals must be generated and the function balanced daily. Proper insurance protection must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. A brief description of the customer service activities involving consigned items is provided below.

CUSTOMER SAFEKEEPING

Safe Deposit Boxes-The branch and the customer enter into a contract whereby the branch receives a fee for renting safe deposit boxes of various sizes. In return for that fee, the branch assumes the responsibility of exercising reasonable care and precaution against loss of the box's contents. When a loss does occur, unless the branch can demonstrate it has maintained the required standard of care, it could be held liable. The required standard of care is defined as that which would be taken by a reasonably prudent and careful person engaged in the same business. Two different keys are required to open the box and the customer and the branch each have one. The customer is not required to disclose the contents of the box to the branch. Generally, the branch may only gain access to the box without the presence of the customer with a court order.

Safekeeping—In addition to items held as collateral for loans, branches occasionally hold

customers' valuables for short periods of time while customers are on vacation or temporarily out of the area. Although it is a convenience for branch customers, many financial institutions attempt to discourage the practice by emphasizing the benefits of a safe deposit box. When it is not possible or practical to discourage a customer, the same procedures that are employed in handling collateral must be followed. Items to be stored should be inventoried by two persons and maintained under dual control in the branch's vault. A multi-copy, pre-numbered, safekeeping receipt should be prepared with a detailed description of the items accepted. Sealed packages with contents unknown to the branch should never be accepted for safekeeping. The branch may or may not charge a fee for the service but if it is the branch's policy to engage in such activity, a definite fee schedule should be adopted.

Custodian Accounts—Branches may act as custodians for customers' investments such as stocks, bonds, or gold. That service may involve simply physically storing the investments and recording sales, purchases, dividends, and interest or it may be expanded to include actually managing the account. Managing the account would include advising when to sell or buy certain investments and meeting the recording requirements. The examiner should refer to Section 3430, "Private Banking" and their respective agencies for guidance on advisory investment management activities.

COLLECTION ITEMS

The collection department is one of the most diversified areas in the branch. It engages in receiving, collecting, and liquidating items, which generally require special handling and for which credit normally is given only after final payment is received. Insofar as collection items are concerned, the branch acts as agent for its customers or correspondents and receives a fee for that service. The importance and value of customer assets under branch control demand the use of accounting procedures adequate to provide a step-by-step historical summary of each item processed. An audit trail must be developed to substantiate the proper handling of

all items and to reduce the branch's potential liability.

CONSIGNED ITEMS

The most common item held on consignment by branches is an inventory of unissued travelers' checks. Travelers' checks have gained widespread popularity because of the possibility of refund if they are lost or stolen. They are issued for a fee or commission shared by the consignor and the issuing institution. Generally, a working supply of unissued travelers' checks is maintained at the teller line or selling station, and a reserve supply is maintained under dual control in the branch's yault.

Rarely does the branch receive sufficient revenues to cover its cost of handling the abovementioned transactions. However, branches that choose to compete at a retail level often must offer a full range of services. Such a branch assumes the responsibility and the related contingent liability to properly maintain the assets of others and to properly record all transactions involved with the above functions. If an employee should, by fraud or negligence, permit unauthorized removal of items held for safekeeping or issue travelers' checks improperly, the branch may be held liable for losses realized. Therefore, it is imperative that branches offering these retail services maintain adequate bonding on all employees wherever contingent liabilities exist.

Consigned Items and Other Nonledger Control Accounts Examination Objectives

Effective date July 1997 Section 4050.2

- To determine if the policies, practices, procedures, and internal controls regarding consigned items and other nonledger control accounts are adequate.
- To determine if branch officers and employees are operating in conformance with the established guidelines.
- 3. To determine the scope and adequacy of the audit function.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient.

Consigned Items and Other Nonledger Control Accounts Examination Procedures

Effective date July 1997

Section 4050.3

- If selected for implementation, complete or update the Consigned Items and Other Nonledger Control Accounts section of the Internal Control Questionnaire.
- Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
- 3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review by internal/external auditors from the examiner
- assigned to Internal and External Audits and determine if appropriate corrections have been made.
- 4. Obtain a listing of consigned items and other nonledger control accounts from the branch.
- Scan any existing control accounts for any significant fluctuations and determine the cause of fluctuations.
- Prepare in appropriate report form and discuss with appropriate officer(s)any recommended corrective action when policies, practices, or procedures are deficient.
- 7. Update the workpapers with any information that will facilitate future examinations.

Consigned Items and Other Nonledger Control Accounts Internal Control Ouestionnaire

Effective date July 1997

Section 4050.4

Review the branch's internal controls, policies, practices, and procedures for consigned items and other nonledger items. The branch's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

SAFE DEPOSIT BOXES

- Has counsel reviewed and approved the lease contract in use that covers the rental, use, and termination of safe deposit boxes?
- *2. Is a signed lease contract on file for each safe deposit box in use?
 - 3. Are receipts obtained for keys to the safe deposit box?
 - 4. Are officers or employees of the branch prohibited from acting as a deputy or having the right of access to safe deposit boxes, except their own or one rented jointly with a member of their family?
 - 5. Is the guard key to safe deposit boxes maintained under absolute branch control?
 - 6. Does the branch refuse to hold, for renters, any safe deposit box keys?
 - 7. Is each admittance slip signed in the presence of the safe deposit clerk and are the time and date of entry noted?
 - 8. Are admittance slips filed numerically?
 - Are vault records noted for joint tenancies and co-rental contracts requiring the presence of two or more persons at each access?
- 10. Are the safe deposit boxes locked when permitting access, and is the renter's key removed and returned to the customer?
- 11. Is the safe deposit clerk prohibited from assisting the customer in looking through the contents of a box?
- 12. Does the safe deposit clerk witness or confirm the re-locking of the box?
- 13. Is each vault booth, after being used but before being assigned to another renter, examined by an attendant to be sure the previous renter did not leave anything of value behind?

- 14. Has a standard fee schedule for this service been adopted?
- 15. Are all collections of rental income recorded when received?
- 16. Are all safe deposit boxes, where the lessee is delinquent in rent, flagged or otherwise marked so that access will be withheld until rent is paid?
- 17. Is a file maintained of all attachments, notices of bankruptcy, letters of guardianship, and letters testamentary, which have been served on the branch?
- 18. Is an acknowledgment of receipt of all property and a release of liability signed upon termination of occupancy?
- 19. Are locks changed when boxes are surrendered, whether or not keys are lost?
- 20. Is drilling of boxes witnessed by two individuals?
- 21. Are the contents of drilled boxes inventoried, packaged, and placed under dual control?
- *22. Are all extra locks and keys maintained under dual control?
- *23. Are such items segregated from branchowned assets and maintained under dual control?
- 24. Is there a set charge or schedule of charges for this service?

ITEMS IN SAFEKEEPING

- 25. Do branch policies prohibit holding items in safekeeping free of charge?
- 26. Are duplicate receipts issued to customers for items deposited in safekeeping?
- 27. Are the receipts prenumbered?
- *28. Is a safekeeping register maintained to show details of all items for each customer?
- *29. Is a record maintained of all entries to custodial boxes or vaults?
- 30. Does the branch refuse to accept sealed packages when the contents are unknown?
- 31. If the branch has accepted sealed packages for safekeeping and the contents are not described, has the approval of the branch's counsel been obtained?
- 32. When safekeeping items are released, are receipts obtained from the customer?

CUSTODIAN ACCOUNTS

(Note that in a bank, these accounts may be handled by the bank's trust department and would thus be reviewed in a separate examination of that department. However, fiduciary activities of U.S. branches of FBOs should be included in safety and soundness examinations.)

- 33. Does the branch have written contracts on hand for each account that clearly define the functions to be performed by the branch?
- 34. Has branch counsel reviewed and approved the type and content of the contracts being used?
- 35. Does the branch give customers duplicate receipts with detailed descriptions, including dates of coupons attached, if applicable, for all items accepted?
- 36. Are those receipts prenumbered?
- 37. Do branch procedures prohibit its holding any investments not covered by a sale or purchase order in this department?
- 38. Are all orders for the purchase and sale of investments properly authorized in the account contract or signed by customers?
- 39. For coupon securities held by the branch:
 - a. Is a tickler file or other similar system used to ensure prompt coupon redemption on accounts where the branch has been authorized to perform that service?
 - b. Are procedures in effect to prevent clipping of coupons where the branch is not authorized to conduct that service?
 - c. Have procedures been adopted to ensure prompt customer credit when coupon proceeds or other payments are received?
- *40. Are all investment items handled in this area maintained under dual control?
- 41. Have procedures been established for withdrawal and transmittal of items to customers?
- *42. Does an officer review and approve all withdrawals before the transaction is effected?
- 43. Has a standard fee schedule for this service been adopted?

COLLECTION ITEMS

44. Is access to the collection area controlled? If so, indicate how?

- *45. Are permanent registers or memorandum accounts maintained for incoming and outgoing collection items?
- 46. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
- *47. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collection items?
- 48. Is a record kept to show the various collection items that have been paid and credited as a part of the day's business?
- 49. Is an itemized daily summary made of all collection fees showing collection numbers and amounts?
- 50. Are employees handling collection items periodically rotated, without advance notification, to other branch duties?
- *51. Is the employee handling collection items required to make settlement with the customer on the same business day that payment of the item is received?
- 52. Does the branch have an established policy of not allowing the customer credit until final payment is received?
- *53. Have procedures been established, including supervision by a branch officer, for sending tracers and inquiries on unpaid collection items in the hands of correspondents?
- 54. In the event of nonpayment of a collection item, is the customer notified and is the item promptly returned?
- 55. Are the files of notes entered for collection clearly and distinctly segregated from branch-owned loans and discounts?
- 56. Are collection notes maintained under memorandum control, and is the control balanced regularly?
- 57. Are collection files locked when the employee handling such items is absent?
- *58. Are vault or locked storage facilities provided for collection items containing negotiable documents?
- 59. Does the collection teller turn over all cash to the paying teller at the close of business each day and start each day with a standard change fund?
- 60. Has a standard fee schedule been adopted for this service?
- 61. Is the fee schedule always followed and, if not, is proper officer approval obtained for any deviations?

- 62. Is a permanent record maintained for registered mail?
- and put in the vault at night over weekends or holidays or is it otherwise protected?
- 67. Are remittances for sales made on a regularly scheduled basis, if not daily?

CONSIGNED ITEMS

- *63. Is the reserve stock of consigned items maintained under dual control?
 - 64. Are working supplies kept to a reasonable minimum, i.e., two or three days' supply, and adequately protected during banking hours?
- *65. Is a memorandum/control account maintained for consigned items?
- *66. Is the working supply safeguarded when the employee handling such items is absent

CONCLUSION

- 68. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 69. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Consigned Items and Other Nonledger Control Accounts Audit Guidelines

Effective date July 1997

Section 4050.5

SAFE DEPOSIT BOXES

- Compare the number of rental contracts in force to the total number of safe deposit boxes
- Determine the current status of rental payments on all boxes rented.
- 3. Determine the reasons for any deviation from established fee schedules.
- Using an appropriate sampling method, test check vault entry records for proper signature(s) of authorized persons.
- 5. Inspect and reconcile the following to inventory control records maintained by the branch:
 - a. Keys for unrented boxes.
 - b. Extra locks and keys kept for replacement purposes.
 - c. Contents of any drilled safe deposit boxes.
- Obtain numbers of safe deposit boxes utilized by the branch and prepare a workpaper detailing all items contained therein.

SAFEKEEPING

- 7. Control all items held in safekeeping through use of seals or otherwise.
- 8. Obtain the safekeeping register to verify that receipt forms are issued in numerical sequence and to account for all numbers issued. Also, check unused forms for the next number to be issued, and test completeness of numerical sequence of unissued forms.
- 9. Using an appropriate sampling technique, select items for test and:
 - Verify the items selected and check the vault contents to the receipt copies on hand.
 - b. If any items selected for review are held in safekeeping elsewhere, confirm their existence by direct communication.
 - c. If any of the items selected for review appear altered or there seems to be a discrepancy between the receipt and what is held in the vault, independently confirm the items with customers.

- Using an appropriate sampling technique, select certain closed items for examination and:
 - Examine the register form and customer's release.
 - b. Compare customer's signature on release to other signature copy on file.
 - c. If any of the items appear altered or unusual, confirm correctness of information with owners.
- 11. Review policies, fee schedule, and procedures for collection of fees for these services and perform appropriate tests to ensure compliance. Confirm that branch policies prohibit holding items in safekeeping free of charge.

CUSTODIAN ACCOUNTS

- 12. Control all items held in custodian accounts through the use of seals or otherwise.
- 13. Using an appropriate sampling technique, select accounts for review and:
 - a. Examine the contract for each account selected.
 - b. Verify the vault contents to the receipt copy on hand.
 - Review transactions and determine compliance with written contractual authorizations.
 - d. If items in an account selected for review are held in safekeeping elsewhere, confirm by direct communication.
 - e. If any items in the accounts selected appear altered or if there appears to be a discrepancy between the receipt and what is held in the vault, confirm the items held with customers.
- 14. Using an appropriate sampling technique, select closed accounts for review and:
 - a. Review the register form and customer's release
 - b. Compare the customer's signature on release to the signature copy on file.
 - If any of the account items appear altered or unusual, confirm correctness of information with owners.
- Review policies and procedures for collection of fees for this service and perform appropriate tests to ensure compliance.

COLLECTION ITEMS

- 16. In the event that permanent registers or memorandum controls are maintained, prepare a trial balance of each account so controlled. Review the register and determine whether:
 - a. all collections are indexed in the register.
 - complete histories of the origin and final disposition of each collection item are recorded.
 - c. receipts are issued to customers for all items received for collection.
- In the case of unusual, altered, or long outstanding items, prepare and mail confirmation requests to customers.
- 18. Using an appropriate sampling technique, select representative items and:
 - a. Review all supporting documents.
 - b. To the extent possible, determine the authenticity of each item selected, and trace and clear each item through final payment, including appropriate credit to customer.
- Test postings of collections on detailed records to determine that disbursement of funds collected is in accordance with customers' instructions.
- Determine that credit is given promptly, on the same day received, for all collections settled.
- 21. Test appropriate records to determine that collection of fees for this service is in

accordance with established policy and that branch income accounts are being credited on a daily basis.

CONSIGNED ITEMS

- 22. Control all items held on consignment through the use of seals or otherwise.
- Inventory unissued and spoiled items on hand and confirm totals to memorandum/ control accounts maintained at the branch.
- 24. Compare and reconcile memorandum accounts to latest consignor statement.
- 25. Prepare and mail to consignor, a confirmation request on items inventoried.
- 26. Follow up and clear any confirmation exceptions.

OTHER NONLEDGER CONTROL ITEMS NOT COVERED ABOVE

- Perform verification procedures considered appropriate in light of any special circumstances encountered.
- Prepare a workpaper documenting procedures used, conclusions reached, and recommendations made.

Branches and other depository institutions use payment systems both to transfer funds related to their own operations and to transfer funds on behalf of their customers. The need for sameday settlement transactions has precipitated financial institutions' increased reliance on electronic funds transfer (EFT) systems. Financial institutions commonly use their EFT operations to make and receive payments, buy and sell securities, and transmit payment instructions to correspondent banks worldwide. In the United States, most of the dollar value of all funds transfers is concentrated in two electronic payment systems: Fedwire, which is a Federal Reserve service, and the Clearing House Interbank Payments System (CHIPS), which is a private settlement system owned and operated by the New York Clearing House Association. The flow of funds through these systems is extremely large compared to the reserve and clearing-account balances maintained by the financial institutions participating in the systems.

The efficiency of a payments system depends to a large extent, on the certainty of settlement of payments. Final settlement occurs when payment obligations between payments system participants are extinguished with final and irrevocable funds. In cash transactions payments, payment and settlement occur simultaneously. On occasion, settlement may not occur on the same day. Without settlement, the recipient of a payment faces the uncertainty of not receiving the value of funds that has been promised. The exposure to this uncertainty is generally referred to as payments system risk. The examiner's role is to ensure that branches effectively monitor and control their exposure to this risk.

The amount and subsequently the velocity of funds transfers that must be settled exposes a branch to many types of specific risk under the general category of payments system risk. In particular, there is liquidity risk, which is the risk that a counterparty may be temporarily unable to cover its obligation to the bank at the time settlement is supposed to occur. There is also credit risk, which is the risk that another participant in the payments system will fail to settle at the end of the day. The provision of intraday credit (often referred to as daylight overdrafts or daylight credit) exposes participants to payments system risk because the provider of the credit may be unable to collect final funds from the receiver at the time payment is due or at all. On those occasions when payments are not settled on the same day, daylight overdrafts may result in overnight (or interday) overdrafts.

TYPES OF PAYMENTS SYSTEMS

The many thousands of payments made each day result in transfers of balances among banks and between banks and Federal Reserve Banks. Additionally, branches make their own payments in connection with carrying out the business of banking. Branches can make interbank payments through accounts that they hold with a correspondent bank.

Electronic Funds Transfer Systems *Fedwire*

The Federal Reserve System operates a national funds-transfer system, Fedwire, and acts as a clearinghouse for transactions executed over the system. Fedwire provides for the electronic transfer of immediate and irrevocable payments between participating institutions and functions as both a clearing and settlement facility for funds and securities transfers, which average more than \$1 trillion per day.

The Fedwire funds-transfer system is a realtime, gross-settlement, credit-transfer system. Each funds transfer is settled individually on the books of the appropriate Federal Reserve Bank as it is processed and is considered a final and irrevocable payment. A depository institution that sends a funds transfer irrevocably authorizes its Reserve Bank to charge its account for the transferred amount and further authorizes the Reserve Bank of the receiving institution to transfer the same amount to the account of the receiving institution. The Federal Reserve guarantees immediate availability of funds. Once the Federal Reserve Bank credits the receiving institution's account or delivers the advice of payment, the Federal Reserve Bank will not reverse credit for the payment. Therefore, there is no settlement risk to the recipient of a Fedwire transfer. The Federal Reserve Bank assumes the risk if the sending bank does not settle its position at the Reserve Bank at the end of the business day. If the sending branch does not settle its position at the Reserve Bank at the end of the business day, the Federal Reserve may be at risk for daylight overdrafts. The use of daylight overdrafts is not encouraged, and banks are subject to credit limits and specific charges set by the Federal Reserve. Furthermore, such daylight overdraft privileges can be revoked at any time.

Branches can access Fedwire in several ways. Many large branches link branch computer facilities and the Federal Reserve over leased telephone lines. Lower volume users usually have dial-up access using microcomputers and Fedline software. Some users are off-line, requiring a separate call to the Federal Reserve for each transaction.

CHIPS

The Clearing House Interbank Payments System (CHIPS) is a funds-transfer network owned and operated by the New York Clearing House Association (NYCHA) to deliver and receive U.S. dollar payments between domestic or foreign banks that have offices located in New York City. The network consists of a small number of settling participants (large U.S.-chartered banks that settle end-of-day balances with each other) and a larger number of nonsettling participants who maintain accounts with one of the settling banks. Although a large volume of CHIPS payments are for settlement of U.S.-dollar foreign-exchange contracts and Eurodollar investments, there are a significant number of domestic business-related transactions. The interbank settlement of payments will normally be completed by the end of the business day. Unlike Fedwire, a credit received through CHIPS may not be a final settlement and can be reversed later in the day. To avoid such reversals, CHIPS has a number of risk-management tools in place. Nevertheless, the receiving institution is subject to some level of intraday credit exposure through the sending institution (or its settling participant) until final settlement is achieved at the end of the business day.

Manual Systems

Not all financial institutions employ an electronic funds transfer system. Branches which execute only a small number of EFT transactions may execute EFTs by a telephone call to a correspondent bank. This is an acceptable practice as long as the branch has adequate internal control procedures.

Message Systems

The message systems employed by institutions and corporations to originate payment orders are indispensable components of funds-transfer activities. Unlike payments systems, which transmit actual debit and credit entries, message systems process administrative messages and instructions to move funds. The actual movement of the funds is then accomplished by initiating the actual entries to debit the originating customer's account and credit the beneficiary's account. If the beneficiary's account or the beneficiary bank's account is also with the originator's bank, the transaction is normally handled internally through "book entry." If the beneficiary-related accounts are outside the originating customer's bank, the transfer may be completed by use of a payments system such as Fedwire or CHIPS. The means of arranging payment orders ranges from manual methods (for example, memos, letters, telephone calls, fax messages, or standing instructions) to electronic methods using telecommunications networks. These networks may include those operated by the private sector, such as SWIFT or Telex, or other networks operated internally by particular financial institutions.

Even though the transfers initiated through systems such as SWIFT and Telex do not result in the immediate transfer of funds from the issuing branch, they do result in the issuing branch having an immediate liability, which is payable to the disbursing institution. Therefore, the operating controls of these systems should be as stringent as the ones implemented for systems such as Fedwire and CHIPS.

SWIFT

Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a nonprofit cooperative of member banks serving as a worldwide interbank telecommunications network based in Brussels, Belgium. It is the primary system employed by financial institutions worldwide to transmit either domestic or international payment instructions.

TELEX

Several private telecommunications companies offer worldwide or interconnected services that provide a printed permanent record of each message transmitted. Telex is the primary message system for institutions that do not have access to SWIFT. The Telex systems do not include built-in security features. Telex users exchange security codes, and senders sequentially number messages sent to another institution.

PAYMENTS SYSTEM RISK (PSR)

Payments system activity gives rise to three forms of risk: direct credit risk to the Federal Reserve in the event that an institution may be unable to cover its intraday overdraft arising from a transfer of funds or receipt of book-entry securities; private direct credit risk to institutions extending daylight credit through private settlement systems; and systemic risk, the possibility that the failure of one participant in a transfer system will cause other participants to fail to meet their obligations.

SUPERVISORY POLICY OVERVIEW

In 1985, the Board of Governors of the Federal Reserve System adopted a policy to reduce the risks that large-dollar payments systems bring to the Federal Reserve Banks, the banking systems, and other sectors of the economy. An integral component of the Federal Reserve's PSR policy is a program to control the use of intraday Federal Reserve credit.

The PSR policy further established limits, or caps, on the amount of Federal Reserve daylight credit that may be used by a depository institution during a single day and over a two-week period. These limits are sufficiently flexible to reflect the overall financial condition and operational capacity of each institution using Federal Reserve payment services. The policy also permits Reserve Banks to protect themselves from the risk of loss by requiring institutions to post collateral to cover daylight overdrafts in certain circumstances or by restricting the account activity of institutions that incur frequent or excessive overdrafts.

In 1992, the Board of Governors approved a policy that established fee assessments for an institution's use of Federal Reserve daylight credit. Along with the daylight overdraft fee policy, the Federal Reserve adopted a modified method of measuring daylight overdrafts that more closely reflects the timing of actual transactions affecting an institution's intraday Federal Reserve account balance.

The objective of daylight overdraft fees is to provide a financial incentive for institutions to control their use of intraday Federal Reserve credit and to explicitly recognize the risks inherent in the provision of intraday credit. Daylight overdraft fees induce institutions to make business decisions concerning the amount of intraday Federal Reserve credit they are willing to use based on the cost of using that credit. As a result, institutions should establish intraday credit limits for customers that actively use payment services.

Under the Federal Reserve's PSR program, each institution that maintains an account at a Federal Reserve Bank is assigned or may establish a net debit cap, which determines the amount of intraday Federal Reserve credit that the institution may use.

U.S. branches and agencies of foreign banks are typically treated the same as domestic institutions under the Federal Reserve's PSR policy. However, several unique considerations affect the way in which the policy is applied to U.S. branches and agencies of foreign banks.

In general, net debit caps for foreign banks are calculated in the same manner as for domestic banks, that is, by applying cap multiples for one of the six cap categories to a capital measure. However, the determination of an appropriate capital measure, known as the U.S. capital equivalency, is substantially different for foreign banks and depends on whether the bank is based in a country that has signed or adopted the standards of the Basle Capital Accord. In addition, special provisions regarding collateralization of overdrafts, allocation of caps, and capital-reporting requirements also apply to foreign banks.

Self-Assessment Caps

Depository institutions that use intraday Federal Reserve credit in amounts that exceed 40 percent of their risk-based capital on a single day or on average over a two-week period must establish their daylight overdraft caps through the self-assessment process.

Unlike other institutions participating in the large payment systems, branches and agencies of foreign banks lack a true U.S. corporate entity against which risk can be evaluated. As a result, the self-assessment is necessarily based upon the foreign-based corporate entity to which the branch(es) and/or agency(ies) belong. This analysis looks to the consolidated entity and all branches and agencies of that entity are combined for purposes of developing a single assessment and adhering to cross-system net debit caps.

For foreign banks with access to the large payment systems in more than one Federal Reserve District, a single branch or agency and Reserve Bank will be designated as the primary contact points for administering this program. That branch or agency will maintain the self-assessment file for all branches and agencies of the same foreign bank for the examiner review. The Administrative Reserve Bank will be responsible for monitoring the consolidated position for all branches and agencies of the foreign bank.

Foreign banks usually lack the type of peer data generally available for domestic institutions. Even where it does exist, the data rarely correspond to that of U.S. counterparts because of different accounting standards. Nonetheless, the absence of peer data does not absolve foreign institutions from going through the same type of analysis as their U.S. counterparts. Indeed, the same general expectations on performance relative to peers means including U.S. peers as well as home country peers, if they expect to rate themselves "above average" or "strong."

Facts regarding a foreign bank's home country may have significant mitigating considerations particularly where local practices result in substantial "hidden reserves," involve significant government support of institutions, or result in other distortions of financial data in ways that can be shown to indicate different degrees of risk than, in fact, actually exists. Explanations of such factors should be well documented in the self-assessment file. While such factors can often cause what would otherwise be regarded as an unsatisfactory rating to be upgraded to satisfactory, further upgrading is unlikely to be acceptable unless the extent of the hidden support is quantified.

If a foreign bank has a deposit-taking subsidiary in the United States, that U.S. institution should be evaluated separately, and its data should be backed out of the foreign parent's data before the self-assessment. Thus, the foreign parent should not "double count" the capital, assets, or liabilities of its U.S. subsidiaries in its self-assessment. For more information, refer to the Guide to the Federal Reserve's Payments System Risk Policy, which is available from any Reserve Bank.

ELECTRONIC FUNDS TRANSFER MANAGEMENT (EFT)

Branches should ensure that prudent banking practices are followed in all funds-transfer activities, and establish guidelines for types of allowable transfers. Procedures should be in effect to prevent transfers drawn against uncollected funds. Transfers should not be initiated against simple ledger balances unless preauthorized credit lines have been established for that account.

Errors and omissions or fraudulent alteration of the amount of a transfer or the account number to which funds are to be deposited could result in losses to the branch. Losses may include total loss of the transferred funds, loss of availability of funds, interest charges, and administrative expenses associated with the recovery of the funds or correction of the problem.

Management is responsible for assessing inherent risks in the EFT system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of safeguards. Regulatory agencies will ensure that each financial institution has evaluated its own risks realistically and has adequate accounting records and internal controls to keep exposures within reasonable, established limits.

The risk associated with any computerized EFT system can be reduced if management implements the controls that are available on the system. For example, the authority to enter, verify, and send transfers can be segregated. Also the dollar amount of the transactions can be limited.

Effective risk management requires that—

 Reasonable credit limits be established and payments in excess of such limits involving

- significant credit risk be properly approved by appropriate lending authorities;
- Banks have adequate recordkeeping to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments, and
- Institutions responsible for settling the position of others should properly monitor respondents' accounts and assign responsibility for this function to an appropriate supervisory level of management.

AUTHENTICATION OR VERIFICATION METHODS

The same due care that financial institutions use when executing EFT transactions must also be used when accepting EFT requests from customers. Management must implement security procedures for ensuring that the transfer requests are authentic. As stated in the Uniform Commercial Code (UCC) section 4A-201, security procedures may require the use of algorithms, or other codes, identifying works or numbers, encryption, call-back procedures, or similar security devices. Authorized and verified payment orders are detailed in the UCC section 4A-202.

Signature Verification

One method to verify the authenticity of a customer's EFT request is to verify the customer's signature; however, this procedure cannot be performed when the customer requests the transaction by telephone. Some financial institutions have implemented policies whereby the customer completes and signs a transfer request, and then faxes the request to the bank. This is not, however, a safe EFT procedure because, although the branch can verify the signature on the faxed request, it cannot be certain that the transfer request is legitimate. Any document that is transmitted electronically can be altered (for example, by changing the amount or account number); the alteration can occur before the document is digitized or after. In most instances, these alterations cannot be detected by the receiving entity. If there is any question about a document's authenticity, the transaction should be reconfirmed through other sources.

Personal Identification Numbers

One way for financial institutions to authenticate transfers initiated over the telephone is through the use of personal identification numbers (PIN) issued to each customer. When a customer requests a transfer, the customer's identity is verified by comparing the PIN that is supplied with the customer PIN request form that is on file. At a minimum, the following safeguards for these types of transfers should be implemented:

- All customers should be requested to sign an
 agreement whereby the branch is held harmless in the event of an unauthorized transfer if
 the branch follows routine authentication procedures. The customer is responsible for
 informing the branch about changes relating
 to individuals authorized to execute EFTs.
 These procedures should minimize the risk to
 the branch in the event someone is able to
 execute a fraudulent transaction. These procedures are described in detail in the UCC
 section 4A-202, Authorized and Verified Payment Orders.
- All transactions over a specific dollar amount should be re-verified by a callback routine.
 The branch should require that the person being called for re-verification is someone other than the person who initially requested the transaction.
- Whenever new PINs are issued, they should be mailed in sealed, confidential envelopes (preferably computer- generated) by someone who does not have the ability to execute wire transfers
- The number of branch employees with access to the PINs should be very limited.

Tape Recording

Tape recording EFT requests made over the telephone is another internal control practice. Likewise, when possible, verifying and recording the incoming telephone number (caller-I.D.). The laws addressing telephone recording vary by state. Some states require that the caller be informed that the conversation is being recorded; other states do not have this requirement. Regardless of the state's law, the branch should inform callers that, for their protection, conversations are being recorded. Moreover, branches should have in place a policy for

archiving the taped telephone records and should retain them for a specified period of time.

Statements of Activity

Some larger branches have implemented a procedure whereby customers are electronically sent a summary statement at the end of each day that lists the transfers executed and received on their behalf. The statement can be sent through a fax machine, personal computer, or remote printer. This procedure can help towards quickly identifying any unauthorized transfers.

Test Keys

EFT requests can also be authenticated by using test keys. A test key is a calculated number that is derived from a series of codes that are contained in a test-key book. The codes in a test-key book represent such variables as the current date, hour of the day, receiving institution, receiving the account number, and amount of the transfer. The value derived from these variables equals the test key. The financial institution or corporate customer initiating the transfer will give its EFT information, along with the test-key value. The receiving institution will recalculate the test key and, if the two test keys equal the same amount, the EFT request is considered authenticated. Test-key code books should be properly secured to prevent unauthorized access or fraudulent use. The use of test keys has declined in recent years as more and more institutions implement personal computerbased EFT systems.

INTERNAL CONTROL

Supervisory Evaluation

Branch management is responsible for assessing the inherent risks in the EFT systems it uses, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of such safeguards. Bank examiners are responsible for ensuring that financial institutions have evaluated their own risks realistically and have provided internal controls that are adequate to keep the exposures within acceptable limits.

Examiners should consider the following internal control guidelines when reviewing policies and procedures covering funds-transfer activities.

- Job descriptions for personnel responsible for a branch's EFT activities should be well defined, and provide for the logical flow of work and adequate segregation of duties.
- No single person in an EFT operation should be responsible for all phases of the transaction.
- All funds transfers should be reconciled at the end of each business day. The daily balancing process should include a reconciliation of both the number and dollar amount of messages transmitted.
- All adjustments required in the processing of a transfer request should be approved by a branch's supervisory personnel, with the reasons for the adjustment documented, particularly in the case of requests as of a past or future date.
- Only authorized persons should have access to EFT equipment.

Considerable documentation is necessary to maintain adequate accounting records and auditing control. Many branches maintain transferrequest logs, assign sequence numbers to incoming and outgoing messages, and keep an unbroken electronic copy of all EFT messages. At the end of each business day, employees who are independent of the transfer function should ensure that all EFT documents are accounted for by comparing request forms to the actual transfers.

Examiners should review the funds-transfer operations to determine that there are accurate and reliable recordkeeping systems, prompt and efficient handling of all transactions, appropriate separation of duties, adequate audit coverage, and recognition by management of the risks associated with those activities.

Payments System Risk and Electronic Funds Transfer Activities Examination Objectives

Effective date July 1997 Section 4060.2

- 1. To determine if electronic funds transfer objectives, policies, practices, procedures, and internal controls are adequate.
- 2. To determine if branch officers and other funds transfer personnel are operating in conformance with established guidelines.
- To determine the scope and adequacy of the audit function as it relates to funds transfer activities.
- To determine that senior management is informed of the current status of and any exposure relative to funds transfer operations.
- 5. To determine compliance with applicable laws and regulations.
- To obtain initiation of corrective action when objectives, policies, procedures or internal controls are deficient or when violations of laws or regulations have been noted.

Payments System Risk and Electronic Funds Transfer Activities Examination Procedures

Effective date July 1997 Section 4060.3

- If selected for implementation, complete or update the Internal Control Questionnaire for this area.
- Based upon an evaluation of internal controls and work performed by internal/external auditors, determine the scope of the examination.
- Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the most current inter-
- nal audit report and determine if appropriate corrections have been made.
- Review the bank's policies with respect to electronic funds transfers and determine their reasonableness.
- 5. For institutions incurring daylight overdrafts, determine that senior management has reviewed and approved the institution assessment and sender net debit cap in conformance with the Federal Reserve Board's policy statement on risk reduction on large-dollar payment systems.

Payments System Risk and Electronic Funds Transfer Activities Internal Control Questionnaire

Effective date July 1997

Section 4060.4

Review the branch's internal controls, policies, practices and procedures regarding wire transfer activities. The branch's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

SIGNATURE CARD CONSIDERATIONS

- Does management maintain a current list of branch personnel authorized to initiate transfer requests?
- 2. Does the branch limit the number of authorized employees?
- 3. Are authorized employee signature cards kept under dual control?
- 4. Does the branch maintain a current list or card file of authorized signers for customers who use the branch's funds transfer services?
- 5. Does the branch limit the number of authorized signers for branch customers?
- 6. Are customer signature cards maintained under dual control or otherwise protected?
- 7. Do customer signature cards limit the amount of funds that an individual is authorized to transfer?
- 8. Does the branch advise its customers to maintain their lists of authorized signers under dual control?
- 9. Do branch personnel compare the signature on an original mail request with the authorized signature on file?

TEST KEY CONSIDERATIONS

- 10. Are the files containing test key formulas maintained under dual control or otherwise protected?
- 11. Are only authorized personnel permitted in the test key area or allowed access to computers, teletapes or terminals?
- 12. Does the branch maintain an up-to-date test key file?
- 13. Does management maintain a list of those persons who have access to test key files?

- 14. Are all messages and transfer requests that require testing authenticated by the use of a test key?
- 15. Are test codes verified by someone other than the person receiving the initial transfer request?
- 16. Are call-back or other authentication procedures performed on all transfers that do not have a test key or signature card on file?
- 17. Do mail transfer requests include a test word as an authentication procedure?
- 18. Does the branch's test key formula incorporate a sequence number resulting from an agreement between the branch and the customer?
- 19. Does the branch have procedures in operation for the issuance and cancellation of test keys?
- 20. Is the responsibility for issuing and canceling test keys assigned to someone who is not responsible for testing the authenticity of transfer requests?

TELEPHONE TRANSFER REQUESTS

- 21. Has the branch established guidelines for what information should be obtained from a person making funds transfer request by telephone?
- 22. Does that information include a test word authentication code?
- 23. Does the branch use a call-back procedure that includes a test code authentication to verify telephone transfer requests?
- 24. Does the branch limit call-back to transactions over a certain dollar amount?
- 25. Does the branch maintain a current list of persons authorized to initiate telephonic funds transfers and messages?
- 26. Does the branch have procedures in effect to prohibit persons who receive telephone transfer requests from transmitting those requests?
- 27. Does the branch use devices that record all incoming and outgoing transfer requests?
- 28. Does the branch advise its customers in written contracts, by audible bleeping signals, or by informing the caller that telephone calls are being recorded?

- 29. Are pre-numbered or sequentially numbered (at a central location after initiation) transfer request forms used?
- 30. Are transfer requests recorded in a log or another branch record at origination?
- 31. Is the log or record of transfer requests reviewed daily by supervisory personnel?
- 32. Do the records of transfer requests contain:
 - A sequence number?
 - · An amount transferred?
 - · The person, firm or institution making request (also specific transferror)?
 - · The date?
 - The test code authentication?
 - Paying instructions?
 - Authorizing signatures for certain types and dollar amount transfers?

WIRE TRANSFER REQUESTS

- 33. Does the branch have teletype or computer terminal equipment capable of receiving and transmitting messages and funds transfer information?
- 34. Are the functions of receipt, testing and transmission of funds transfer requests performed by different employees?
- 35. Are incoming and outgoing messages time stamped or sequentially numbered for control?
- 36. Do incoming and outgoing messages include a test word or code as a means of message authentication?
- 37. Is an unbroken copy of all messages kept throughout the business day?
- 38. Is that copy reviewed and controlled by someone not connected with operations in the wire transfer area?

ACCOUNTING, PROCESSING, AND SYSTEMS

- 39. Does the wire transfer department of the branch prepare a daily reconcilement of funds transfer activity by dollar amount and number of messages?
- 40. Is a daily reconcilement of funds transfer activities performed in another area of the branch, i.e., correspondent banks, accounting,

- or by a person divorced from any money transfer operations?
- 41. Are all pre-numbered forms, including cancellations, accounted for in the daily reconcilement?
- 42. Is the daily reconcilement of funds transfer and message request activity reviewed by supervisory personnel?
- 43. Is the balancing of the daily activity separate from the receiving, processing and sending functions?
- 44. Does the wire transfer department verify that work sent to other branch departments agrees with its totals?
- 45. Is someone responsible for reviewing all transfer requests to determine that they have been properly processed?
- 46. Are all rejects and/or exceptions reviewed by someone not involved in the receipt, preparation or transmittal of funds?
- 47. If the institution accepts transfer requests after the close of business or transfer requests with a future value date, are they properly controlled and processed?
- 48. Are Federal Reserve Bank statements reviewed daily to determine if there are "open" funds transfer items and the reasons for the outstanding items?
- 49. Are corrections, overrides, open items, reversals and other adjustments reviewed and approved by an officer?
- 50. Does the wire transfer department or another area of the branch have procedures in effect to prohibit transfers of funds against accounts that do not have preauthorized credit availability and have uncollected balances?
- 51. Does the branch maintain adequate records as required by the Currency and Foreign Transactions Reporting Act of 1970 (also known as the Bank Secrecy Act)?
- 52. Have managing officers adopted written procedures or flowcharting to serve as a training tool?
- 53. Does management and/or the audit department undertake a periodic review to ensure that work is being performed in accordance with established policy?
- 54. Is the audit department promptly informed when a change is made in systems or method of operation?
- 55. Are all general ledger tickets, automated transaction cards or other supporting documents initialed?

PERSONNEL

- 56. Has the branch taken steps to ensure that screening procedures are applied to personnel hired for sensitive positions in the wire transfer department?
- 57. Does the branch prohibit new employees from working in sensitive areas of the wire transfer operation?
- 58. Are temporary employees excluded from working in sensitive areas? If not, is the number of such employees limited?
- 59. Are statements of indebtedness required of employees in sensitive positions of the wire transfer function?
- 60. Are employees subject to unannounced rotation of responsibilities regardless of the size of the institution?
- 61. Are relatives of employees in the wire transfer function precluded from working in the same institution's bookkeeping or data processing departments?
- 62. Does the branch's policy require that employees take a minimum number of consecutive days as part of their annual vacation? Is this policy being enforced?
- 63. Does management reassign employees who have given notice of resignation or been given termination notices, from sensitive areas of the wire transfer function?

PHYSICAL SECURITY

- 64. Is access to the wire transfer area restricted to authorized personnel?
- 65. Are visitors to the wire transfer area identified, required to sign in and be accompanied at all times?
- 66. Is written authorization given to those employees who remain in the wire transfer area after normal working hours? Who gives such authority? Are security guards informed?
- 67. Are branch terminal operators or others in wire transfer operations denied access to computer areas or programs?
- 68. Do procedures prohibit computer personnel from gaining access to branch terminals or test key information?
- 69. Does wire transfer equipment have physical and/or software locks to prohibit access by unauthorized personnel at all times?

- 70. Are terminals and other hardware in the wire transfer area shut down after normal working hours? Are they regulated by automatic time-out controls or time-of-day controls?
- 71. Are passwords suppressed when entered in terminals?
- 72. Are operator passwords frequently changed? If so, how often?
- 73. Is supervisory approval required for terminal access made at other than authorized times?
- 74. Are passwords restricted to different levels of access such as data files and transactions that can be initiated?
- 75. Is terminal operator training conducted in a manner that will not jeopardize the integrity of live data or memo files?
- 76. Are employees prohibited from taking keys for sensitive equipment out of the wire transfer area?
- 77. Does the branch maintain back-up communications systems?
- 78. Are back-up systems periodically tested by branch personnel?
- 79. Does the use of back-up equipment require approval by supervisory personnel?

CONTINGENCY PLANS

- 80. Have written contingency plans been developed for partial or complete failure of the systems and/or communication lines between the branch and the New York Clearing House, Federal Reserve Bank, data centers and/or servicer companies?
- 81. Are these contingency plans reviewed regularly and tested periodically?
- 82. Has management distributed these plans to all wire transfer personnel?
- 83. Are sensitive information and equipment adequately secured before evacuation in an emergency and is further access to the affected areas denied by security personnel?

CREDIT EVALUATION AND APPROVAL

84. Have customer limits been established for Fedwire, CHIPS, and Cash Wire exposure which include consideration of intraday and overnight overdrafts?

- a. Are groups of affiliated customers included in such limits?
- b. How often are the limits reviewed and updated?
- c. Are the customer limits reviewed by senior management? How frequently?
- 85. Does the branch make payments in anticipation of the receipt of covering funds? If so, are such payments approved by officers with appropriate credit authority?
- 86. Are intraday exposures limited to amounts expected to be received the same day?
- 87. Are intraday overdraft limits established in consideration of other types of credit facilities for the same customer?
- 88. Is an intraday posting record kept for each customer showing opening collected and uncollected balances, transfers in, transfers out, and the collected balances at the time payments are released?

- 89. If payments exceed the established limits, are steps taken in a timely manner to obtain covering funds?
- 90. When an overnight overdraft occurs, is a determination made as to whether a fail caused the overdraft? If so, is this properly documented? Is adequate follow-up made to obtain the covering funds in a timely manner?

CONCLUSION

- 91. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Compliance Introduction

Effective Date July 1997

Section 5000.1

Head office management should develop adequate policies and procedures to ensure that the branch is in compliance with all applicable U.S. federal and state laws and regulations, including reporting and special supervisory requirements.

To the extent possible given the size, risk profile and organizational structure of the branch, these responsibilities should be vested in a branch official or compliance officer whose function is separate from line management. The compliance officer should be qualified and familiar with U.S. and state laws and regulations.

Branch management and the compliance officer should ensure that all appropriate personnel are properly trained in meeting regulatory requirements on an ongoing basis. In addition, the training program should ensure that branch personnel are informed of U.S. and state laws and regulations to which the branch may be subject.

The scope of the branch's audit function also should ensure that the branch is meeting all applicable regulatory requirements. The head office should ensure that the audit team is qualified to audit its U.S. branch operations for compliance with U.S. and state laws, regulations, and regulatory reporting requirements.

Financial Recordkeeping and Reporting Regulations Effective date July 1997 Section 5010.1

Information, plus the examination objectives and examination procedures relating to this section are available in the Federal Reserve Board's *Bank Secrecy Act Manual* and other similar examination material of the other federal and state banking agencies.

Effective date July 1997

Asset maintenance was originally developed as a method of ensuring that, in the event of a liquidation, sufficient assets would be available to effect repayment to depositors and liability holders. Although asset maintenance is not a capital equivalent, branches under asset maintenance have some of the characteristics of a separately capitalized entity. In fact, in the early stages of asset maintenance, ratios of 108 percent and 105 percent were established to be roughly equivalent to the then-prevailing capital ratios of U.S. domestic banks.

Generally, asset maintenance is defined as the maintenance of eligible assets in a branch in a particular state, covering a specified percentage of a branch's third party liabilities. The asset maintenance calculation is determined by dividing eligible assets by liabilities requiring cover.

Asset maintenance is generally defined and enforced by the licensing agency. Examiners should consult the appropriate regulation of the appropriate agency to define and calculate the ratio. Asset maintenance may also be imposed by regulators through the issuance of supervisory action. The supervisory imposition of asset maintenance has significant effects on the branch depending upon the percentage imposed. When imposed at levels above 100 percent, a branch must maintain a net due to related parties position at all times. This effectively prevents the branch from providing net funding to the head office or other related offices. Asset maintenance levels below 100 percent would have the effect of limiting the net due from related parties position.

Asset maintenance requirements will differ by state. Some states do not require coverage for all third party liabilities booked at the branch (e.g. IBF deposits). Therefore, even though a branch meets the state's asset maintenance requirements, the branch may still be in a net due from affiliates position. In the event of a financially weak FBO, regulators may consider expanding the asset maintenance requirements to further define eligible assets and liabilities to ensure adequate coverage of all third party deposits.

State licensing authorities may impose asset maintenance as a requirement of licensure within that state. The FDIC imposes asset maintenance as a requirement for receiving deposit insurance.

Asset maintenance may also be imposed at individual branches or FBO offices as a form of

supervisory action for the U.S. operations of a foreign banking organization. This action may relate to supervisory concerns raised in determining the financial strength of the FBO, including circumstances in the home country that could adversely affect the FBO's U.S. operations. Asset maintenance, in these instances, may be necessary, even though the U.S. operations are in satisfactory condition.

As a result of statute, regulation, or supervisory agreement, special requirements and guidelines for determining the amount of eligible assets and calculating the asset maintenance percentage may be required by the appropriate regulatory agency. These requirements will necessitate the maintenance of specific records at the branch. A branch under asset maintenance will also be required to periodically report asset maintenance compliance to the appropriate regulators. Examiners should determine whether the daily record and the monthly report for asset maintenance are appropriately maintained and reported.

ASSET MAINTENANCE CALCULATION

The first part of the asset maintenance calculation requires a determination of eligible assets. To determine eligible assets, the examiner deducts the ineligible assets from the gross asset position of the branch. Ineligible assets fall into two categories: those that are Ineligible by Statute, and those that are Ineligible by Examiner.

Assets Ineligible By Statute

Generally, assets that are Ineligible By Statute might include the following:

- Any type of asset not specifically identified as eligible by statute or regulation by the appropriate licensing agency;
- Any other asset that fails to meet specific eligibility standards contained in the statute or regulation by the appropriate licensing agency.

The specific assets that are Ineligible By Statute will vary according to the requirements 5020.1 Asset Maintenance

contained in federal and state laws and regulations. The following is representative of some of the requirements that may be imposed. Any asset for which:

- Evidence of indebtedness (original signed note or loan agreement) is not held in the United States or the state within which the branch is licensed:
- Evidence of indebtedness is in transit within the FBO system, either outside the United States or outside the state in which the branch is licensed:
- Repayment is to be made in funds not freely convertible to U.S. dollars;
- Reclassification to an expense category is pending.

In addition requirements may be imposed on:

- Types of securities and depreciation;
- The documentation and collection of loans;
- The type, location, holding, and depreciation of fixed assets:
- All amounts due from the head office and other depository and nondepository offices and affiliates, including income accrued but uncollected on such amounts.

The balance of any asset disallowed at the preceding examination will be treated as ineligible until the underlying reasons for the disallowance have been removed.

Assets Ineligible By Examiner

If an examiner, during the course of an examination, determines that the value of any nonmarketable bond, note, debenture, or any other asset would preclude complete repayment, the examiner may consider that asset ineligible for asset maintenance purposes. The portion considered unrecoverable is disallowed.

Disallowances of classified assets will differ based on the criteria or guidelines used by the various regulatory agencies. The following formula is representative of some of the disallowances that may be used: Loss—100 percent of book value; Doubtful—50 percent of book value; Substandard—20 percent of book value, and Value Impaired—100 percent of the amount equivalent to the Allocated Transfer Risk Reserve, plus 20 percent of any residual expo-

sure. In addition, all accrued interest on assets subject to a Loss, Doubtful, Substandard, or Value Impaired classification is usually disallowed.

An examiner may also disallow any loan or other credit exposure that is not supported by sufficient credit information (in English) to permit an evaluation of the creditworthiness or other risks inherent in the asset. Examiners are to exercise prudence in disallowing assets for this reason.

Situations may arise where an asset can be disallowed for both statutory and discretionary reasons. For example, a loan may be disallowed by statute because the evidence of indebtedness is not held in the state where the branch is located. Additionally, the loan may be classified Substandard, Doubtful, Loss, or Value Impaired. In this case, the branch (for periodic reporting to the regulators) and/or the examiner can disallow the asset by statute and classify the loan. Of course, no further disallowance is made on the basis of the asset classification.

Where an asset is controlled jointly by the branch and a related party, it is necessary to determine whether the branch has independent control (i.e. the ability to withdraw the asset without a cosignatory). If so, the item should not be disallowed simply because another office retains signing authority.

By definition, a certificate-less security (those represented by advises or confirmations) cannot be in the owner's possession. Nevertheless, this type of security may be an eligible asset, even if the depository is located outside the state where the branch is located, provided that both of the following conditions are met: (1) The security is held by the depository in the name of the branch or in the name of an unrelated broker, agent, or custodian (the exchange member) who is located in the state where the branch is licensed; and (2) The asset is properly shown on the branch's records so as to permit the appropriate regulators to freeze the account immediately upon taking possession of the branch.

Reserves maintained at the local Federal Reserve Bank, pursuant to Regulation D, and assets pledged to the FDIC, in connection with deposit insurance regulations, are eligible assets. Securities held by the Federal Reserve Bank as collateral against possible borrowing are eligible on the same basis as if held by the branch. The amount of any borrowing must be deducted from the value determined.

Asset Maintenance 5020.1

Liabilities Requiring Coverage

Once eligible assets are determined, the asset maintenance computation requires a determination of liabilities requiring cover. Generally, liabilities requiring cover include all liabilities of a branch and may even include certain contingent liabilities, as determined by the appropriate regulators. The liabilities will be adjusted to exclude the following:

- Amounts due and other liabilities to other offices, agencies, branches, and affiliates of the FBO, including unremitted profits;
- Reserves for loan losses and other contingencies;
- Any other liability, as specifically required by statute, regulation, or the appropriate regulators.

Asset Maintenance Examination Objectives

Effective date July 1997

Section 5020.2

- To determine if internal policies, procedures, and guidelines regarding asset maintenance are adequate.
- 2. To determine that branch officers and employees are operating in conformance with established guidelines.
- 3. To determine compliance with laws and regulations or supervisory requirements.
- To evaluate the accuracy of periodic asset maintenance reports submitted to the appropriate regulators.
- To evaluate specific books and records that may be required for the continual monitoring of asset maintenance.
- To determine whether the internal audit function adequately reviews asset maintenance compilation, review, and reporting.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Asset Maintenance

Examination Procedures

Effective date July 1997

Section 5020.3

The following procedures will determine if the branch under examination has established satisfactory periodic reporting, operating standards, and audit procedures regarding asset maintenance. Examiner discretion is required in applying these procedures.

- Review applicable statutes, regulations, and/or supervisory requirements for asset maintenance.
- Test compliance with policies, practices, procedures, and internal controls for appropriate asset maintenance monitoring.
- Obtain the most recent asset maintenance report filed with the regulators and determine its accuracy. If necessary, review previous submissions to determine any trends in reporting errors.
- 4. Verify that eligible assets, as included in the filed reports, are correct. Ensure that, in addition to credits, categories such as due from related parties, securities, fixed assets, and other assets have been appropriately adjusted.
- Test check the asset maintenance computation for accuracy with statutory and supervisory requirements. Ensure that liabilities requiring cover have been appropriately adjusted.
- Review assets considered ineligible by the branch for appropriateness and compliance with laws, regulations, and supervisory requirements.
- 7. Determine that assets purchased by the branch are properly reflected at fair market value. While fair market value may be difficult to determine, it should, at a minimum, reflect both the rate of return being earned on such assets and an appropriate risk premium. Determine that appropriate write-offs are taken on any assets sold by the branch at less than book value.
- Review credits acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination, to determine that the

- branch has appropriate agreements evidencing the acquisition and credit documentation.
- 9. Review credit classifications for appropriate inclusion in asset maintenance reports.
- 10. Review credits that have been classified and/or are considered as problems by management. If credits have been internally classified, test whether they and their associated accrued interest receivable have been appropriately removed from eligible assets.
- 11. Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous examination, or, for any other reason, were considered to be of questionable quality.
- 12. Scan the delinquency lists submitted to the head office to determine that reports are sufficiently detailed to evaluate risk factors that could possibly identify credits that might be considered Ineligible By Examiner.
- Compile a listing of all loans not supported by current and satisfactory credit information, collateral documentation, and evidences of indebtedness.
- Ascertain whether loans are purchased on a recourse basis and are sold on a nonrecourse basis.
- 15. Verify that asset maintenance monitoring and reports filed with appropriate regulators are reviewed for compliance by branch management and that internal controls are adequate.
- Organize and prepare a listing of violations of asset maintenance laws, regulations, and supervisory requirements.
- 17. Prepare the following examination report pages:
 - Ineligible Assets
 - Asset Maintenance and Pledge Schedule
- Prepare comments for the Compliance and Violation of Laws and Regulations pages, if necessary.
- Prepare a complete set of workpapers to support conclusions and examination report pages and discuss all material findings with management.

Asset Pledge and Capital Equivalency Deposits

Effective date July 1997

Section 5030.1

Asset pledge or capital equivalency deposit accounts may be established as a requirement for licensing a branch. These accounts are designed to provide a ready source of liquid assets to begin to pay for the expenses of a liquidation, in the event it became necessary to take possession of a branch.

Federal and state licensing authorities may prescribe, by statute or regulation, requirements and conditions under which the branch will establish, maintain, and conduct an asset pledge or capital equivalency deposit account. These conditions and requirements will vary from one regulatory agency to another. However, the following represents some of the conditions or requirements that may be imposed:

- Balance in the account may be a specific dollar amount and/or a variable amount based on a specified percentage of third party liabilities (i.e., related party liabilities and other specific liabilities are usually excluded);
- Guidelines for establishing the account (i.e., account must be held by a third party, in the name of the licensing authority);

- Types of assets available for pledging or deposit (i.e., certificates of deposit, U.S. government securities, etc.);
- Conducting transactions (i.e., regulatory approval for deposits and withdrawals and direct confirmation to the licensing authority may be required).

Asset pledge or capital equivalency deposit accounts, in severe problem situations, can also be used as a form of supervisory follow-up action. When severe problem situations are encountered, the licensing authority may require an upward adjustment by the branch in the balance of the applicable account. This may be done by increasing the, normally required, specific dollar amount and/or the variable amount, based on a specified percentage of third party liabilities. The amount of the increase should be sufficient to give the regulators additional funds to cover expenses associated with a branch liquidation.

Suspicious Activities Effective date July 1997

Section 5040.1

Current information on this topic is available in the Federal Reserve Board's Bank Secrecy Act Manual and similar examination material of the other federal and state banking agencies.

Effective date July 1997

The Board of Governors of the Federal Reserve System amended Regulations D and Q effective December 3, 1981, to permit U.S. depository institutions, Edge and Agreement Corporations and U.S. branches and agencies of FBOs to establish International Banking Facilities (IBFs) in the United States.

The Board's objective was to enhance the international competitive position of banking institutions in the United States by permitting, through an institution's IBF, similar deposit reserve and tax treatment afforded to offshore banking offices. As a result, an IBF was permitted to maintain a lower rate of reserves on IBF liabilities maintained in excess of IBF assets. When adjustments to the deposit reserve requirements were made in September 1990, an IBF's relative advantage with respect to deposit reserves was effectively eliminated. However, in some states, there still remain tax advantages to maintaining IBFs. Furthermore, many FBOs continue to use their IBFs as funding vehicles on the assumption that former reserve requirements may be reestablished.

Examinations of IBFs are ordinarily conducted in conjunction with examinations of the branches operating those facilities, and follow the same supervisory procedures.

While a branch is not required to establish a separate organization for IBF operations, it is required to segregate on its books, the asset and liability accounts included in the IBF.

In general, IBFs may accept deposits from and extend credit to non-U.S. residents or other IBFs. The Board's rules impose various restrictions and limitations on the type of business in which an IBF can engage. These restrictions were designed to avoid complicating the conduct of domestic monetary policy and insulate U.S. economic activity from IBF transactions. As outlined in Regulation D, Section 204.8, these restrictions include:

- Prohibiting the lending to or accepting of deposits from a U.S. resident, other than the branch establishing the IBF or other IBFs;
- Prohibiting the acceptance of transaction accounts:
- Prohibiting the issuance of negotiable or bearer instruments;
- Requiring nonbank deposits to carry a minimum maturity or required notice period of two business days; bank deposits can be made with overnight maturities;
- Subjecting nonbank customer transactions to a minimum deposit or withdrawal amount of \$100,000, except to close out an account or withdraw accumulated interest;
- Requiring the IBF to notify its nonbank customers, in writing, at the time an account relationship is first established that the deposits received by the IBF may be used only to support its non-U.S. operations, and extensions of credit by the IBF may be used only to finance the customers' non-U.S. operations. In the case of customers that are foreign affiliates of U.S. residents, the IBF is required to obtain acknowledgment of the receipt of such notice.

Branches may book off-balance-sheet items in the IBF, provided the customer and the transactions comply with applicable regulations. Generally, off-balance-sheet items are booked at an IBF to take advantage of favorable tax rates or to hedge IBF assets and liabilities. Examiners should review the reasons for booking such items in the IBF and determine the appropriateness of such action.

In addition, certain states impose further restrictions and requirements governing the establishment and maintenance of IBFs. The examiner should review these restrictions and requirements prior to establishing the scope of the review.

International Banking Facilities Examination Objectives

Effective date July 1997

Section 5050.2

- To determine if policies, practices, procedures, and internal controls regarding IBFs are adequate.
- To determine if branch officers are operating in conformance with the established guidelines.
- 3. To determine the scope and adequacy of the audit function.
- 4. To determine compliance with laws and regulations.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

International Banking Facilities Examination Procedures

Effective date July 1997

Section 5050.3

- Complete or update the Internal Control Ouestionnaire if selected for implementation.
- 2. Review applicable statutes, regulations, and/or supervisory requirements for asset maintenance.
- 3. Review IBF ledgers to determine that IBF accounts are clearly segregated from the establishing entity's books. (Note: IBF ledgers may be integrated with the establishing entity's general ledger or may be maintained as a separate general ledger. If the ledgers are included with the establishing entity's regular accounts, the IBF accounts must be clearly labeled. IBF assets need not balance with IBF liabilities.)
- 4. Determine the adequacy of the internal audit procedures used to check compliance with applicable regulations. Obtain a list of any deficiencies noted in the latest review performed by the internal auditors and determine if corrections have been made.
- 5. In addition to verifying application of the branch's standard review, analysis, and/or documentation of IBF-booked credits and deposits, evaluate the adequacy of procedures by reviewing a sample of accounts to ensure that:
 - a. All deposits, extensions of credit, and off-balance-sheet items are extended to or accepted from qualified customers, i.e., foreign residents, other IBFs, and offices of the branch establishing the IBF
 - Nonbank extensions of credit are used only to finance the non-U.S. operations of the customer.
 - Nonbank deposits are used only to support the non-U.S. operations of the customer.
 - d. Nonbank customers are provided written notice of the Federal Reserve Board of Governors' policy statement at the time the deposit or credit relationship is first established advising of the requirement regarding the non-U.S. use of deposits and credit extensions.
 - e. In the case of loans to or deposits from foreign affiliates of U.S. corporations,

- verify that written confirmation is obtained acknowledging receipt of the Board of Governors' policy. (Note: IBF transactions with foreign governments and official institutions are treated in the same manner as IBF transactions with foreign banks, i.e. written notice of the non-U.S. use of funds is not necessary.)
- Nonbank deposits meet the minimum maturity or required notice period for withdrawal of two business days.
- g. Nonbank time deposits and withdrawals (except for account closings and withdrawals of accumulated interest) meet the minimum size transaction amount of \$100,000.
- h. Deposit confirmations state that funds are being placed in an IBF and that the depositor must abide by IBF restrictions as defined by the Board of Governors of the Federal Reserve System.
- 6. Review all intrabank transactions for an appropriate time period to determine that:
 - a. All transactions with the U.S. offices of the IBF's own branch are clearly identifiable.
 - b. Eurocurrency liabilities are properly reported by the IBF's establishing branch.
- 7. Review IBF purchases from and sales to third parties to determine that:
 - a. Such assets are IBF eligible assets, and appropriate notices and acknowledgments have been provided and uses of proceeds documented.
 - The transactions are at arms length, without recourse.
 - The transactions are not conducted with affiliates, other than the branch establishing the IBF.
- Review all IBF-related regulatory reports, e.g., the FFIEC-002 and FR 2951, if applicable, to determine their timely submission and accuracy.
- 9. Discuss apparent violations and procedural deficiencies with appropriate officer(s).
- 10. Prepare comments in appropriate report form for all violations and deficiencies noted.

International Banking Facilities Internal Control Questionnaire

Effective date July 1997

Section 5050.4

DEPOSITS

- 1. Are all deposits from foreign residents, other IBFs, or offices of the branch establishing the IBF?
- 2. Do liabilities consist only of time deposits, borrowings, placements taken, or similar instruments?
- 3. Has it been determined that no banker's acceptances, certificates of deposit or other liabilities have been issued in negotiable or bearer form?
- 4. Do all foreign nonbank deposits meet the minimum maturity or notice period to withdraw of two business days?
- Do nonbank time deposits or withdrawals (except closeouts or withdrawals of accumulated interest) meet the minimum size transaction amount requirement of \$100,000?
- 6. Have procedures been established to ensure that nonbank deposits received from non-U.S. residents or foreign affiliates of U.S. corporations are used only to support the non-U.S. operations of the depositor or its affiliates located outside the United States?
- 7. Does the branch provide written notice to each of its nonbank customers at the time a deposit or credit relationship is first established, advising of the Board's policy regarding the use of IBF deposits and loans outside the United States?
- 8. In the case of loans to or deposits received from foreign affiliates of U.S. corporations, is a written confirmation obtained from such customers, acknowledging receipt of the Board of Governors' policy statement?

EXTENSIONS OF CREDIT

9. Are extensions of credit granted only to qualified customers, that is, foreign resi-

- dents, other IBFs, and the branch establishing the IBF?
- 10. Do credits consist only of loans, advances, placements, securities, or any other form of credit transaction?
- 11. Have procedures been developed to reasonably ensure that credits granted are being used only to finance operations outside the United States?
- 12. Is documentation available to substantiate that funds are only being utilized outside the United States?

INTRABANK TRANSACTIONS

- 13. Are all transactions with the U.S. offices of the IBF's own branch or other IBFs clearly identifiable?
- 14. Are Eurocurrency liabilities to the IBF being properly reported by the U.S. offices of the IBF's own branch?

OTHER

- 15. Is the establishing branch properly maintaining segregated or otherwise identifiable accounts for its IBF operations?
- 16. Do all assets and liabilities and off-balancesheet items of the IBF qualify under the definitions in Regulations D and Q and other regulatory provisions applicable to IBFs?
- 17. Are IBF-related regulatory reports filed in a timely manner and were they found to be correct?
- 18. Is management thoroughly familiar with the provisions of Regulations D and Q and the limitations and restrictions established by the Board of Governors for IBFs?

Effective date July 1997

The regulatory agencies rely on the timely and accurate filing of regulatory reports by domestic and foreign financial institutions. Data collected from regulatory reports facilitate early identification of problem situations. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended various banking statutes to enhance the Federal Reserve's authority to assess civil money penalties against state member banks, bank holding companies and FBOs that file late, false, or misleading regulatory reports. The civil money penalties also can be assessed against individuals who cause or participate in such filings including those who sign officially submitted reports.

FILING

The Federal Reserve has identified a late regulatory report as an official copy of a report that is not received by the Reserve Bank or its designated electronic collection agent in a timely manner. The filing of a completed original report is timely in the following cases:

- The report is received by the Reserve Bank at the end of the reporting day on the submission deadline, including reports filed electronically;
- The report is mailed first class and is postmarked no later than the third calendar day preceding the submission deadline, no matter when the report is received by the district Federal Reserve Bank. In the absence of a postmark, an institution may be called upon to provide proof of timely mailing, if the report has been received after the submission deadline: or
- The completed original report is delivered to an overnight package delivery service on the day before the submission deadline. An institution may be called upon to provide proof of timely delivery to the service, if the report has been received after the submission deadline.

The filing of a false report generally involves the submission of mathematically incorrect data, such as addition errors or transpositions, the submission of call reports without appropriate schedules, or the inadvertent filing of inaccurate information. Conversely, the filing of a misleading report involves some degree of knowing or reckless behavior on the part of the filer and the intentional or negligent submission of inaccurate information to the Federal Reserve.

FEDERAL RESERVE REGULATORY REPORTS MONITORING SYSTEM

The Federal Reserve System has a Regulatory Reports Monitoring Program (program) to identify those banking institutions under its supervision that file late and false reports. Each Reserve Bank maintains records of late and false reporters and submits summary reports of these records to Board staff after every reporting period.

To promote consistent treatment under the program, the Reserve Banks may not grant grace periods or extensions of the submission dates of regulatory reports. In addition, the program requires Board staff responsible for enforcement actions to consult with Reserve Bank staff to ensure that appropriate follow-up supervisory actions are taken, and that the Federal Reserve addresses all instances of chronic late and false regulatory reporting through civil money penalties or other enforcement proceedings.

REVIEW OF REGULATORY REPORTS

Review of regulatory reports involves determining whether the management of the branch has submitted all required reports to the Federal Reserve in a timely and accurate manner. The examiner assigned to a specific department in the branch is responsible for reviewing those reports relating to that department and verifying that the reports are accurate, meet statutory and regulatory requirements, and agree with the branch's financial records. The examiner-incharge is to consolidate the findings of the examination team and submit a list of regulatory reporting errors to the appropriate Reserve Bank staff, who will determine the extent to which the branch will be required to file amended reports.

Examiners should discuss with Reserve Bank staff any regulatory report that is considered misleading as such a report could lead to the issuance of suspicious activities report(s) against

the involved branch and/or individual(s). In addition, management should be reminded that civil money penalties may be assessed or other enforcement proceedings may be initiated against regulatory report filers who are chronically late or repeatedly file seriously inaccurate reports.

Branches should maintain efficient internal systems and procedures to ensure that reporting is made in accordance with the appropriate regulatory requirements. They should develop clear, concise, and orderly workpapers to support the compilation of data. Preparation of proper workpapers not only provides a logical tie between report data and the branch's financial records but also facilitates accurate reporting and verification.

A branch's internal control program for regulatory reports should ensure that all required reports are submitted on time and are accurate. The specific internal controls employed by a branch to meet those objectives depend largely on the volume of reports, the scope of a branch's operations, and the complexity of its accounting system.

REQUIRED REGULATORY REPORTS

This section describes the regulatory reports required to be submitted by the branch to the Federal Reserve. In addition to the list of reports outlined below, the examiner should also review the reports that monitor compliance with asset maintenance requirements, which are applicable under state law or are required for federally-licensed or -insured branches. For additional information on state requirements, refer to the Summary of Key State Statutes in the appendix of this manual.

Report of Assets and Liabilities of U.S. Branches & Agencies of Foreign Banks (FFIEC 002 and 002S)

All branches are required to file a report of assets and liabilities (known as the call report), as of the last day of each calendar quarter. Details of the appropriate reporting guidelines, along with the specific report form to be filed, are found in the Instructions for Preparation of the Report of Assets and Liabilities of

U.S. Branches and Agencies of Foreign Banks (FFIEC 002).

The branch should submit the completed call reports to the appropriate supervisory agencies no more than 30 calendar days after the report date. The Federal Reserve acts as the collecting and processing agent of the call report for the federal supervisory authorities.

The examiner should carefully review the report to ensure that all pertinent data has been reported and is properly categorized in accordance with the call report instructions. To review a particular branch's call report, the examiner must first understand the branch's accounting methods and the information located in, and the relationships between, the branch's general ledger and subsidiary ledgers. Workpapers used in the preparation of the report and supplementary schedules will aid the examiner in understanding the branch's system.

Other Regulatory Reports

Other regulatory reports include the following:

1. Weekly Report of Assets and Liabilities by Large U.S. Branches and Agencies of Foreign Banks. (FR 2069)

Frequency: Weekly.

Voluntary series-branches selected by Board staff that had more than \$1.1 billion in total assets in March 1991.

2. Report of Transaction Accounts,

Other Deposits and Vault Cash (FR 2900) Frequency: Weekly.

Aggregate worldwide assets in excess of \$1 billion.

3. Monthly Report of Foreign

Currency Deposits (FR 2915)

Frequency: Monthly

Aggregate worldwide assets in excess of \$1 billion.

4. Report of Certain Eurocurrency

Transactions (FI

(FR 2951)

Frequency: Weekly.
Aggregate worldwide assets in excess of \$1 billion.

5. Country Exposure Report for U.S. Branches and Agencies of

Foreign Banks

(FFIEC 019)

Frequency: Quarterly.

Direct claims on foreigners in excess of \$30 million.

6. Monthly Consolidated Foreign

Currency Report

(FFIEC 035)

Frequency: Monthly.

Commitments to purchase foreign currency or U.S. dollar exchange of more than \$1 billion. Other criteria may be used for selection. Verify reporting status during examination.

7. Weekly Foreign Currency Report (FC-1) Frequency: Weekly.

Foreign exchange contracts aggregating \$100 million or more. Other criteria may be used for selection. Verify reporting status during examination.

The following U.S. Treasury Department reports are collected to gather information on international capital movements by U.S. banks (and their Edge Act and agreement corporations), other depository institutions, international banking facilities, bank holding companies, and U.S. branches and agencies of foreign banks; a U.S. \$15 million (or equivalent) threshold applies to reporting institutions:

 Liabilities to Foreigners, Payable in Dollars (BL-1);

- Custody Liabilities to Foreigner (BL-2);
- Intermediary's Notification of U.S. Nonbank Borrowing From Foreigners, Payable in Dollars (BL-3);
- Claims on Foreigners, Payable in Dollars (BC);
- Part 1. Claims on Foreigners (BQ-1); Part 2.
 Domestic Customers' Claims on Foreigners Held by Reporter;
- Part 1. Liabilities to and Claims on Foreigners Payable in Foreign Currencies (BQ-2);
 Part 2. Domestic Customers' Claims on Foreigners (in foreign currencies);
- Purchases & Sales of Long-Term Securities by Foreigners (S).

Applicable laws and regulations require branches to file certain reports relating to specific business activities. For example, branches are required to file reports associated with lost and stolen securities, transfer agent activities, municipal securities dealer activities, government securities broker and dealer activities, criminal referrals, and BSA reporting. Specific comments relating to these activities are discussed under in the Other Compliance Matters section of this manual. The examiner-in-charge should identify all applicable reporting requirements of the branch and coordinate the review of those reports.

Review of Regulatory Reports Examination Objectives

Effective date July 1997

Section 5060.2

- 1. To determine that required reports are being filed on time.
- 2. To determine that contents of reports are accurate.
- 3. To determine the adequacy of the internal audit function as it relates to reviewing and preparing the regulatory reports.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Review of Regulatory Reports Examination Procedures

Effective date July 1997

Section 5060.3

- Complete or update the Internal Control Questionnaire if selected for implementation.
- Determine the branch's historical record of submitting timely and accurate reports by reviewing workpapers.
- 3. Depending on the scope of the examination, select certain regulatory reports or portions of reports for review. Obtain the most recent filing of the selected reports or portions of reports and perform the following:
 - a. Reconcile the line items shown on the reports to the appropriate general ledger, subsidiary ledgers, or daily statements.
 - b. Obtain the workpapers applicable to each line item and reconcile individual items to the reports.
 - Determine the accuracy of electronic reporting systems used in the preparation of reports.
 - d. Determine whether other examiners have uncovered any misstatement of assets or

- liabilities during their examination of the various departments.
- Determine that the reports are prepared in accordance with Federal Reserve and/or other applicable instructions.
- Review scope of internal audit to determine if it covers the preparation and review of regulatory reports.
- 5. Prepare comments in appropriate report form and discuss with management recommended corrective action when policies, practices or procedures are deficient or when reports have been filed incorrectly, late, or not at all. The comments must include, if applicable, the name(s) and the as of date(s) of amended report(s) and the date of filing, amount of, and explanation of any material difference.
- 6. Update the workpapers with any information that will facilitate future examinations.

Review of Regulatory Reports Internal Control Questionnaire

Effective date July 1997

Section 5060.4

- 1. Are regulatory reports accurate and submitted in a timely manner?
- 2. Is there adequate separation of duties to ensure that the raw data used to complete regulatory reports is compiled by one person and verified by another person before submission?
- 3. After the regulatory reports are prepared but before their submission, are they checked by:
 - a. The supervisor of the department preparing the report, who takes personal responsibility for its accuracy and submission on a timely basis?
 - b. Branch personnel who have no part in the report's preparation?
- 4. If regulatory reports are produced electronically:
 - a. Are accurate reports produced in a form acceptable to the applicable regulatory agencies?
 - b. Are changes to the electronic systems documented and approved by an autho-

- rized officer responsible for the preparation of the reports?
- 5. Do regulatory report workpapers:
 - a. Leave a clear audit trail from the raw data to the finished report, and are they readily available for inspection?
 - b. Meet record retention standards under applicable laws and regulations?

CONCLUSION

- Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- Based on the information gathered, evaluate the internal controls of this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Effective date July 1997

FBOs are subject to various other federal and state laws and regulations not discussed elsewhere in this manual. Similar to domestic banking organizations, FBOs operating in the United States are required to be knowledgeable of these laws and regulations and to establish policies, practices, procedures, and internal controls to ensure compliance.

The following discussion is divided into two sections: Safety and Soundness Rules and Regulations and Consumer Compliance Regulations. State-licensed branches should refer to their state statutory codes for specific statutes that may apply. Additionally, federally-insured branches are subject to the wide variety of laws and regulations applicable to all federally-insured depository institutions.

On January 17, 1978, the three federal bank supervisory agencies issued a joint policy statement to address their concern regarding the potential for improper payments by banks and bank holding companies in violation of the Foreign Corrupt Practices Act and the Federal Election Campaign Act. While not widespread, the federal bank supervisory agencies were concerned that such practices could reflect adversely on the banking system and constitute unsafe and unsound banking practices, in addition to their possible illegality.

The potential devices for making political payments in violation of the law could include compensatory bonuses to employees, designated expense accounts, fees or salaries paid to officers, and preferential or zero interest rate loans. In addition, political contributions could be made by providing equipment and services without charge to candidates for office.

SAFETY AND SOUNDNESS RULES AND REGULATIONS

Foreign Corrupt Practices Act—15 USC 78DD-1, 78DD-2

Beginning in 1973, the Securities and Exchange Commission (SEC) became aware of conduct by some companies involving the use of corporate funds for illegal domestic political contributions. Subsequent SEC investigations, revealed instances in which some of the largest U.S. corporations had secretly engaged in the bribery of foreign officials. In the course of these

investigations, it became apparent that, in many instances, these activities were concealed from the outside auditors and others by maintaining off-the-book bank accounts or otherwise circumventing the system of internal accounting controls.

As a result of these investigations, Congress passed the Foreign Corrupt Practices Act of 1977 (Act). This Act consists of two separate groups of rules: (a) those that prohibit the offering or payment of bribes to certain foreign officials, and (b) those requiring the maintenance of complete accounting books and records and an effective system of accounting controls.

Section 78DD-1 applies to any issuer of securities registered on a U.S. national securities exchange. Thus, if an FBO has issued securities so registered, the prohibition on certain corrupt practices applies to the FBO. Section 78DD-2, however, applies to any domestic concern, which is defined in subsection (h)(1)(B) to include any corporation which has its principal place of business in the United States. Generally, questions of specific applicability of provisions of this Act to U.S. branches and agencies of FBOs should be referred to appropriate legal counsel.

Antibribery Provisions

These provisions of the Act prohibit any U.S. company or business entity (and its officers, directors, agents, employees, and shareholders acting on its behalf) from using the mails, telephone, transportation, or any other instrumentality of interstate or foreign commerce corruptly, in furtherance of an offer, payment, promise to pay, authorization of the payment of any money, or other thing of value to:

- An official of a foreign government or instrumentality of a foreign government;
- A foreign political party or official thereof or a candidate for political office; or,
- Any other person the payor knows of or has reason to know, who will pay or give the money or value to those listed above,

where the purpose is to influence an act or decision (including a decision not to act) of the recipient in his official capacity or to induce the recipient to use his or her influence to affect or influence an act or decision of the government or instrumentality, in order to assist such company or entity in obtaining, retaining, or directing business for itself or another person.

These provisions do not apply to payments to any employee whose duties are essentially ministerial or clerical.

Accounting Provisions

Although the obligation to maintain accurate books and records and to have an adequate system of internal accounting controls has been acknowledged by responsible corporations for a long time, this obligation was not previously explicitly established into law until the passage of the Act. Applying essentially to all companies whose securities are publicly traded in the United States, the Act requires them to:

- Make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and
- Devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that:
 - Transactions are executed in accordance with management's general or specific authorizations;
 - Transactions are recorded as necessary

 (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and
 (2) to maintain accountability for assets;
 - Access to assets is permitted only in accordance with management's general or specific authorization; and,
 - The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any difference.

Acting under its authority to issue regulations, the SEC issued regulations, which became effective on March 23, 1979, concerning falsifications of records and the making of false, misleading, or incomplete statements to auditors. The first of these regulations says that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to the provisions of the law described above, that is, those used for making reports under the SEC laws.

The second regulation prohibits a director or officer of an issuer from making or causing to be made a materially false or misleading statement, and from omitting to state or cause another person to omit a material fact necessary to make a statement not misleading to an accountant, external or internal, in connection with an audit of the financial statements or preparation of required reports. Conviction of a willful violation of these accounting provisions carries a possible \$10,000 fine or up to five years imprisonment, or both.

Federal Elections Campaign Act— 2 USC 441B

The Federal Elections Campaign Act (FECA), enacted in 1971, was designed to curb potential abuses in the area of federal election financing. In general, FECA regulates the making of campaign contributions and expenditures in connection with primary and general elections to federal offices and specifically bans campaign contributions by national banks. The Office of the Comptroller of the Currency has, by regulation (12 CFR 28.101(4)), made this provision applicable to federal branches and agencies.1 FECA does not specifically address the making of contributions and expenditures by banks or other corporations to advocate positions on issues that are the subjects of public referenda. As originally enacted, FECA required disclosure of contributions received or expenditures made; however, amendments to the law in 1974 and 1976 imposed additional limitations on contributions and expenditures as well. The 1974 amendments also established the Federal Election Commission (Commission) to administer FECA's provisions. The Commission is responsible for adopting rules to carry out FECA, for rendering advisory opinions, and for enforcing the Act. The Commission was reorganized as a result of the FECA Amendments of 1976 and it has since issued regulations interpreting the statute Title 11 of the CFR.

^{1. 2} USC 441a, however, limits campaign contributions by any person. The definition of person in 2 USC 431(h) is very broad and could include the U.S. branches and agencies of FBOs. Accordingly, any questions in this area should be referred to appropriate legal counsel. In addition, 2 USC 441e prohibits campaign contributions by foreign nationals (the definition of which excludes U.S. citizens and U.S. permanent resident aliens).

Contributions and Expenditures

The words contribution and expenditure are defined broadly by FECA and the Commission's regulations to include any loan, advance, deposit, purchase, payment, distribution, subscription, gift of money, or anything of value that is made for the purpose of influencing the nomination or election of any person to federal office. The payment by a third party of compensation for personal services rendered without charge to a candidate or political committee is also treated as a contribution by FECA, although the term does not include the value of personal services provided by an individual without compensation on a volunteer basis.

Although loans are included in the definitions of contribution and expenditure under FECA, a specific exemption is provided for bank loans made in the ordinary course of business and in accordance with applicable banking laws and regulations. The Commission's regulations provide further that extensions of credit to a candidate, political committee, or other person in connection with a federal election may be treated as a loan, and not a contribution, if they are on terms substantially similar, in risk and amount, to those made to nonpolitical debtors. The regulations also provide that a debt may be forgiven only if the creditor has treated it in a commercially reasonable manner, including making efforts to collect the debt, which are similar to the efforts it would make with a nonpolitical debtor. In considering whether a particular transaction is a contribution or a loan, it is expected that a factor would be the extent to which the creditor may have departed from its customary credit risk analysis.

FECA and the implementing regulation permit certain limited payments to candidates or their political committees. For example, payment of compensation to a regular employee, who is providing a candidate or political committee with legal or accounting services, which are solely for the purpose of compliance with the provisions of the FECA, is exempt from the definitions of contribution and expenditure. The Commission's regulations also permit occasional use of a corporation's facilities by its shareholders and employees for volunteer political activity; however, reimbursement to the corporation is required for the normal rental charge for anything more than occasional or incidental use.

Separate Segregated Funds and Political Committees

FECA allows the establishment and administration by corporations of separate segregated funds to be utilized for political purposes (2 USC Section 441b(b)(4)). While corporate monies may not be used to make political contributions or expenditures, corporations may bear the costs of establishing and administering these separate segregated funds, including payment of rent for office space, utilities, supplies, and salaries. These costs need not be disclosed under FECA. Commission regulations also permit a corporation to exercise control over its separate segregated fund.

In practice, most corporate segregated funds are administered by a group of corporate personnel, which, if the fund receives any contributions or makes any expenditures during a calendar year, constitutes a political committee, as defined by FECA. As such, it is required to file a statement of organization with the Commission, to keep detailed records of contributions and expenditures, and to file with the Commission reports identifying contributions in excess of \$200 and candidates who are recipients of contributions from the fund.

Solicitation of contributions to corporate segregated funds by political committees must be accomplished within the precise limits established by FECA. All solicitations directed to corporate employees must satisfy the following requirements: (1) the contribution must be entirely voluntary, (2) the employee must be informed of the political purposes of the fund at the time of the solicitation, and (3) the employee must be informed of his or her right to refuse to contribute without reprisal. Beyond those basic requirements, FECA distinguishes between executive and administrative personnel and other employees. The former and their families may be solicited any number of times, while the latter and their families may only be solicited through a maximum of two written solicitations per year, and these solicitations must be addressed to the employees at their homes. Solicitations may also be directed to corporate stockholders and their families in the same manner as to executive and administrative personnel.

Although a corporation or a corporation and its subsidiaries may form several political committees, for purposes of determining the statutory limitations on contributions and expenditures, all committees established by a corporation and its subsidiaries are treated as one. Thus, the total amount that all political committees of a corporation and its subsidiaries may make to a single candidate is \$5,000 in any federal election (provided that the committees are qualified multicandidate committees under FECA).

Violation of FECA by any corporation is punishable by a fine of not more than \$25,000, and any director or officer of any corporation who consents to any contribution or expenditure by the corporation in violation of FECA is subject to fine or imprisonment or both.

State laws concerning this matter should also be reviewed by the examiner. However, FECA preempts state law with respect to election to federal office.

Bank Bribery Act—18 USC 215

The Comprehensive Crime Control Act of 1984 amended the federal bank bribery law to prohibit employees, officers, directors, agents, and attorneys of financial institutions from seeking or accepting anything of value in connection with any transaction or business of their financial institution. The definition of a financial institution in 18 USC 20(9) includes a U.S. branch or agency of an FBO. The amended law also prohibited anyone from offering or giving anything of value to employees, officers, directors, agents, or attorneys of financial institutions for or in connection with any transaction or business of the financial institution. Because of its broad scope, the 1984 Act raised concerns that it might have made unlawful what had previously been considered acceptable conduct.

In July 1985, the Department of Justice issued a Policy Concerning Prosecution Under the New Bank Bribery Statute. In that policy, the Justice Department discussed the basic elements of the prohibited conduct under Section 215, and indicated that cases to be considered for prosecution under the new bribery law entail breaches of fiduciary duty or dishonest efforts to undermine financial institution transactions. Because the statute was intended to reach acts of corruption in the banking industry, the Justice Department expressed its intent not to prosecute insignificant gift giving or entertaining that does not involve a breach of fiduciary duty or dishonesty.

Congress decided that the broad scope of the statute provided too much prosecutorial discretion. Consequently, Congress adopted the Bank Bribery Amendments Act of 1985 to narrow the scope of 18 USC 215 by adding a new element, namely, an intent to corruptly influence or reward an officer in connection with financial institution business.

This law now specifically excepts the payment of bona fide salary, wages, fees or other compensation paid, or expenses paid or reimbursed in the usual course of business. In addition, the law now requires the financial institution regulatory agencies to publish guidelines to assist employees, officers, directors, agents, and attorneys of financial institutions in complying with the law. The branch's internal code or written policy should prohibit such persons from (1) soliciting for themselves or for a third party (other than the branch itself) anything of value from anyone in return for any business, service, or confidential information of the branch and from (2) accepting anything of value (other than bona fide salary, wages, and fees) from anyone in connection with the business of the branch, either before or after a transaction is discussed or consummated. In addition, the code/policy may specify appropriate exceptions to the general prohibition of accepting something of value in connection with branch business.

Furthermore, the branch's code of conduct or written policy should provide that if a branch official is offered or receives something of value beyond what is permitted in the policy, that branch official must disclose that incident to an appropriately designated official of the financial institution. The branch should maintain such disclosures. A branch official's full disclosure evidences good faith when it is made in the context of properly exercised supervision and control. Management should review the disclosures and determine that what is accepted is reasonable and does not pose a threat to the integrity of the branch. Thus, the prohibitions of the bank bribery statute cannot be avoided by simply reporting to management the acceptance of various gifts.

The business luncheon or holiday season gift from a customer generally is not a violation of the statute if: (1) its acceptance is based on a family or personal relationship existing independent of any business of the financial institution, (2) the benefit is available to the general public under the same conditions on which it is available to the branch, or (3) the benefit would be paid for by the branch as a reasonable business expense if not paid for by another party. What is

reasonable in one part of the country may appear lavish in another part. Thus, the branch may establish, in its own code/policy, a range of dollar values, which cover the various benefits that its officials may receive from those doing or seeking to do business with the branch.

In addition to the exceptions discussed above, the branch may describe other appropriate exceptions to the general prohibition in its code of conduct or written policy, such as those that:

- Permit acceptance of meals, refreshments, travel arrangements, accommodations, or entertainment, all of reasonable value and in the course of a meeting or other occasion the purpose of which is to hold bona fide business discussions, provided that the expenses would be paid for by the branch as a reasonable business expense, if not paid for by another party;
- Permit acceptance of loans from other branches or financial institutions on customary terms to finance proper and usual activities of branch officials, such as home mortgage loans, except where prohibited by law;
- Permit acceptance of advertising or promotional material of reasonable value, such as pens, pencils, note pads, key chains, calendars, and similar items;
- Permit acceptance of discounts or rebates on merchandise or services that do not exceed those available to other customers:
- Permit acceptance of gifts of reasonable value that are related to commonly recognized events or occasions, such as a promotion, new job, wedding, retirement, Christmas, or bar or bat mitzvah;
- Permit the acceptance of civic, charitable, educational, or religious organizational awards for recognition of service and accomplishment.

A serious threat to the branch's integrity occurs when its officials become involved in outside business interests or employment that give rise to a conflict of interest. Such conflicts of interest may evolve into corrupt transactions that are covered under this Act. Accordingly, the branch is encouraged to prohibit in its code/policy, branch officials from self-dealing or otherwise trading on their positions with the branch or accepting a business opportunity from someone doing or seeking to do business with the branch, which is not available to other persons or which is made available to the branch

official because of such person's position with the branch.

If the value of the item or benefit offered or received exceeds \$100, the offense is a felony punishable by up to thirty years imprisonment and a fine of up to \$1,000,000 or three times the value of the bribe or gratuity, whichever is greater. If value does not exceed \$100, the offense is a misdemeanor punishable by up to one year imprisonment and a maximum fine of \$1,000.

Foreign Assets Control Regulation

The function of the Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury is to promulgate and administer regulations dealing with the economic sanctions that the U.S. government imposes against certain foreign countries, against the nationals of those countries, and against the specially designated nationals of those countries. Under the International Emergency Economic Powers Act, the President can impose sanctions such as trade embargoes, freezing of assets, import surcharges, etc. These sanctions usually entail the freezing of a country's assets and are politically motivated. Branches must block funds transfers that (1) are remitted by or on behalf of a blocked individual or entity; (2) are remitted to or through a blocked entity; or (3) are remitted in connection with a transaction in which a blocked individual or entity has an interest. If a branch in the U.S. receives instructions to make a payment that falls into one of these categories, it is required to execute the payment order and place the funds into a blocked account. A payment order cannot be canceled or amended after the U.S. branch has received it. Once assets or funds are blocked, they may be released only by specific authorization from the U.S. Treasury.

A "specially designated national" is a person or entity who acts on behalf of one of those countries under economic sanction by the U.S. The designation is done by the U.S. Secretary of State. Dealing with such nationals is prohibited. Moreover, their assets or accounts in the U.S. are frozen. In certain cases, however, the Treasury Department can issue a license to a designated national. This license can then be presented by the customer to the institution, allowing the institution to debit his/her account. The license can be either general or specific. The general

license is not a document but a provision in the regulation itself authorizing certain transactions; the branch must request the customer to sign an affidavit stating that the particular transaction is covered by a general license. The specific license is a document (with U.S. Treasury seal, signature of OFAC's Chief of Licensing and control number) issued by OFAC on a case-by-case basis to a specific individual or company allowing an activity that otherwise is prohibited by the regulations; the branch must request to see the original license.

Blocking an account allows only credits to be posted to a customer's account. If OFAC imposes the blocking of an account, then the account cannot be used to settle claims, i.e., the branch is prohibited from offsetting the account; no debiting is allowed. Assets can also be blocked whereby the Treasury Department exercises powers and privileges associated with ownership of all property and interests in property of the sanctioned country's government, its agencies, instrumentalities, and controlled entities in the United States or within the possession or control of U.S. persons. An institution's correspondent banks accounts can also be blocked or frozen. The branch is not allowed to tell its customer if his/her account has been blocked by OFAC.

A 602 Request is a national emergency inquiry requested by the U.S. Secretary of State. The U.S. government does not need an injunction order for this request, and the recipient of such a request must respond to the inquiry.

Any violation of the regulations implementing the sanctions subjects the violator to criminal prosecution. Criminal penalties for violating sanctions range up to 12 years in prison and \$1 million in corporate fines and \$250,000 in individual fines, per incident. In addition, civil penalties of up to \$250,000 per violation may be imposed administratively.

Regulation K, International Banking Organizations—12 CFR 211

The Board of Governors of the Federal Reserve System's Regulation K, Subpart B was issued under the authority of the Bank Holding Company Act of 1956 (BHCA) and the International Banking Act of 1978 (IBA). It applies to FBOs with respect to:

- limitations on interstate banking;
- exemptions from the nonbanking prohibitions of the BHCA and the IBA;
- the approval of the establishment of an office of a foreign bank in the U.S.;
- the termination of a foreign bank's branch or agency;
- the examination of an office of a foreign bank in the U.S.:
- the disclosure of supervisory information to a foreign supervisor; and
- the limitations on loans to one borrower by state branches and state agencies of a foreign bank

The following is a brief summary of Regulation K:

Section 211.21—Definitions

This section includes all the definitions for this subpart. Included in this section is the definition of *agency* and *credit balances*. Refer to the Deposit Accounts section of this manual for additional information on credit balances.

Section 211.22—Limitation on Interstate Banking

This section addresses the designation of a home state for the foreign organization. The Federal Reserve Bank District in which a foreign organization's home state is located, is considered the organization's "responsible Reserve Bank."

Section 211.23—Nonbanking Activities of FBOs

This section exempts certain FBOs from the nonbanking prohibitions of the BHCA and IBA. An organization must qualify for exemption from these prohibitions by meeting certain asset, revenue, and net income requirements. If an organization does not meet the qualifications, or ceases to be eligible for the exemption, the organization may apply to the Federal Reserve Board for a specific determination of its eligibility. Refer to the regulation for details. If an organization qualifies for this exemption, it may engage in certain activities and investments cited in the regulation. Refer to the regulation for a listing of such activities and investments.

Section 211.24—Approval of Offices of Foreign Banks; Procedures for Applications; Standards for Approval; Representative-Office Activities and Standards of Approval; Preservation of Existing Authority

This section addresses the application procedures and approval process for branches, agencies, representative offices, and commercial lending companies of foreign banks. The section also lists the activities in which a representative office may engage. In addition, this section requires uninsured federal and state branches, uninsured state branches, all state agencies, and all representative offices to file a suspicious activity report in accordance with the Federal Reserve Board's Regulation H.

Section 211.25—Termination of Offices of Foreign Banks

This section addresses the grounds under which a foreign bank may be required to terminate the activities of its representative office, commercial lending company subsidiary, or state branch or agency. The section also includes termination procedures. The license of a federal branch or agency would be terminated by the OCC. A state branch or agency license can only be terminated by the respective state's banking authority.

Section 211.26—Examination of Offices and Affiliates of Foreign Banks

This section requires an annual on-site examination of each branch, agency, or commercial lending company of a foreign bank by:

- the Federal Reserve Board;
- the FDIC, if the branch is FDIC insured;
- the OCC, if the branch or agency is licensed by the Comptroller; or
- the state supervisor, if the branch or agency is licensed by the state.

To the extent possible, these examinations should be coordinated with all the regulatory agencies; and the examination of all U.S. offices of the FBO should be conducted simultaneously.

Section 211.27—Disclosure of Supervisory Information to Foreign Supervisors

As the title suggests, this section addresses the disclosure of information to a foreign banking regulatory or supervisory authority. Refer to the regulation for details.

Section 211.28—Limitation on Loans to One Borrower

Except as otherwise provided in this section, the aggregate of all outstanding loans and extensions of credit at one time to a single borrower by all state and federal branches and agencies of the same FBO are subject to the limitations and other provisions of section 5200 of the Revised Statutes (12 USC 84). Section 5200 of the Revised Statutes (12 USC 84) limits loans and extensions of credit to a person outstanding at one time which are not fully secured, to 15% percent of the unimpaired capital and unimpaired surplus for the association. Separate from and in addition to this 15% limitation, loans and extensions of credit to a person outstanding at one time which are fully secured by readily marketable collateral having a market value, are limited to 10% of unimpaired capital and unimpaired surplus of the association. In the case of a branch, the "unimpaired capital and unimpaired surplus of the association" is the unimpaired capital and unimpaired surplus of the FBO as reported on the FBO's Annual Report of FBO (FR Y-7). Section 5200 allows for some exemptions to these limits; however, the examiner should place the burden of proof upon the branch to justify qualifications for these exemptions.

Regulation D, Reserve Requirements of Depository Institutions— 12 CFR 204

The Board of Governors of the Federal Reserve System's Regulation D was issued under the authority of section 19 (12 USC 461) and other provisions of the Federal Reserve Act and of section 7 of the IBA (12 USC 3105). The regulation relates to the reserves that depository institutions are required to maintain. The reserve requirements apply to a foreign bank's branch or agency located in the U.S., in the following instances:

- its parent bank has total worldwide consolidated bank assets in excess of \$1 billion;
- its parent bank is controlled by a foreign company or group of foreign companies that own or control foreign banks that in the aggregate have total worldwide consolidated bank assets in excess of \$1 billion; or
- the branch is eligible to apply to become a FDIC-insured bank.

Refer to the regulation for information on the calculation and maintenance of reserves. Section 5060 of this manual also addresses the regulatory reports required to calculate reserves. The examiner assigned the review of regulatory reports should determine whether any violations of Regulation D exist.

Bank Secrecy Act—31 USC 5311, et seq. and 31 CFR Part 103, et seq./ Regulation H, Section 208.14

Refer to the Federal Reserve System's *Bank Secrecy Act Manual* for information on these rules and regulations.

Transfer Agent Activities

If a branch acts as a transfer agent for the stock of its holding company or any other equity security, it may have to register with the Board of Governors as a transfer agent, pursuant to the requirements of Regulation H (section 208.8(f)), by filing uniform interagency Form TA-1. A discussion of the responsibilities of a branch as a transfer agent, the reports and filing requirements, and other information, including examination procedures, are contained in the Board's *Transfer Agent Examination Manual*. The Board has developed a separate Report of Examination of Transfer Agents.

Municipal Securities Dealer Activities

A branch that is a municipal securities dealer must register with the SEC and with the Board as a municipal securities dealer, pursuant to SEC Rule 15Ba2-1, by filing Form MSD. A discussion of the responsibilities as a municipal securities dealer, filing requirements, and other information, including examination procedures,

is contained in the Board's *Municipal Securities Dealer Examination Manual*. The Board has developed a separate Report of Examination of Municipal Securities Dealer Activities.

Government Securities Broker and Dealer Activities

If a branch acts as a government securities broker and/or dealer, it may have to file notice with the Board as a government securities broker and/or dealer pursuant to section 15C(a)(1)(B) of the Securities Exchange Act of 1934, by filing Form FR G-FIN. A discussion of the branch's responsibilities as a government securities broker and/or dealer, filing requirements, and other information, including examination procedures is contained in the Board's *Procedures for the Examination of Government Securities Activities*. The Board has developed a separate Summary Report of Examination of Government Securities Broker/Dealer or Custodial Activities.

Lost and Stolen Securities Reporting and Inquiry Requirements— 17 CFR 240.17F-1

A branch with deposits insured by the Federal Deposit Insurance Corporation (reporting institution) must register with the Securities and Exchange Commission's designee, Securities Information Center, Inc. (SIC) and report lost, missing, stolen, or counterfeit securities to the SIC. Each insured branch is responsible for contacting the SIC to determine if securities coming into its possession, whether by pledge, transfer or some other manner, have been previously reported as missing, lost, stolen, or counterfeit, except in certain limited circumstances.

All functions within a branch that handle or process securities are subject to the reporting requirements. Only the transfer agent function is exempt from the inquiry requirements. Accordingly, all branch departments likely to be affected, including the trust, investment, transfer agent, custody or dealer departments, and the lending operations as relating to margin loans, should be familiar with the requirements set out in 17 CFR 240.17F-1.

Securities exempt from the reporting requirements are:

- Registered securities of the U.S. government and federal agencies thereof;
- Securities that have not been assigned CUSIP numbers; and,
- Bond coupons.

Securities exempt from the inquiry requirements are:

- Securities received directly from the issuer or its agent at issuance;
- Securities received from another reporting institution or from a Federal Reserve Bank or branch:
- Securities received from a customer of the reporting institution in the name of the customer or nominee; and,
- Securities that are a part of a transaction of \$10,000 or less (aggregate face value for bonds or market value for stocks).

Reporting Lost, Missing, Stolen or Counterfeit Securities

Form X-17F-1A must be filed with the SIC within one business day after the discovery of:

- A theft or loss of any security, when there is a substantial indication of criminal activity;
- A security that has been lost or missing for two business days; or
- · A security that is counterfeit.

The form must be filed within two business days of notification of nonreceipt when (1) delivery of securities sent by the branch is made by mail or by draft and payment is not received within ten business days and confirmation of nondelivery has been made by the receiving institution and (2) delivery is made in person and no receipt is maintained by the branch. If securities sent by the branch, either in person or through a clearing agency, are lost in transit and the certificate numbers of the securities can be determined, the branch must supply the receiving institution with the certificate numbers of the securities within two business days from the date of the request from the receiving institution. The delivery of lost or missing securities to the branch must be reported within one business day after discovery and notification of certificate numbers. Securities that are considered lost or missing as a result of counts or verifications must be reported no later than ten

business days after discovery or as soon as certificate numbers can be ascertained.

Copies of all reports required to be filed under 17 CFR 240.17F-1 must also be submitted to the registered transfer agent for the issue being reported and, if criminal activities are suspected, to the Federal Bureau of Investigation. Copies of filed or received Forms X-17F-1A must be maintained in an easily accessible place for three years.

CONSUMER COMPLIANCE REGULATIONS

Since the late 1960s, Congress has enacted a number of consumer protection and civil rights laws directly related to the activities of financial institutions. Traditionally, these laws have been enforced by the domestic institution's primary federal regulator; for example, the Board of Governors conducts consumer compliance examinations for state member banks. More recently, as part of the Federal Deposit Insurance Corporation Improvement Act of 1991, Congress expanded the authority of the Board and other federal banking agencies to enforce consumer statutes for certain types of FBOs.

Specifically, the Federal Reserve System is responsible for enforcing consumer laws in the case of state-licensed agencies and state-licensed uninsured branches of FBOs, commercial lending companies owned or controlled by FBOs and organizations operating under section 25 or 25(a) of the Federal Reserve Act (Edge Act and Agreement corporations). In addition, the Office of the Comptroller of the Currency is responsible for conducting these examinations for federally-licensed, uninsured branches of FBOs and the Federal Deposit Insurance Corporation is responsible for federally-insured branches of FBOs.

The scope of a typical compliance examination for these institutions includes the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, the Truth in Lending Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Electronic Fund Transfer Act, the Federal Trade Commission Act, and the Expedited Funds Availability Act. The degree to which FBOs operating in the U.S. conduct activities covered by these laws and regulations vary, but often these institutions conduct far fewer such activities than a typical domestically-chartered bank.

Examinations of entities of FBOs should be conducted using existing regulatory policies and procedures for domestically-chartered bank compliance examinations. Examiner guidelines for conducting compliance examinations and investigating consumer complaints are contained, for example, in the Board of Governor's Consumer Compliance Handbook and various supervisory Consumer Affairs letters. These guidelines describe the examination procedures to be used in connection with loan file sampling, reporting and correcting violations, and rating branches for compliance. Of particular importance are violations that require reimbursement of overcharges and violations that trigger corrective action under the Board's Regulation B/Fair Housing Act Policy Guide.

Following is a description of some of the regulations and consumer protection laws that Federal Reserve System examiners enforce. This information is provided primarily as reference material; examiners should consult the detailed handbooks mentioned earlier for specific examination guidance in this area.

Regulation B/Equal Credit Opportunity Act

The Equal Credit Opportunity Act prohibits discrimination against an applicant for credit because of age, sex, marital status, religion, race, color, national origin, or receipt of public assistance. It also prohibits discrimination because of a good faith exercise of any rights under the federal consumer credit laws. The law also contains notification requirements for consumers and small businesses that have been denied credit.

Regulation C/Home Mortgage Disclosure Act

The Home Mortgage Disclosure Act requires certain lending branches to report annually on their originations and purchases of home purchase and home improvement loans and applications for such loans. The type of loan, location of property, race or national origin, sex, and income of the applicant or borrower are reported to supervisory agencies. Branches are required to make information regarding their lending

available to the public and must post a notice of availability in their public lobby.

Regulation E/Electronic Funds Transfer Act

The Electronic Funds Transfer Act provides consumer protection for all transactions using a debit card or other electronic means to debit or credit an account. For example, it also limits a consumer's liability for unauthorized electronic fund transfers, restricts issuance of debit cards, and requires certain disclosures.

Regulation Z/Truth In Lending Act

Regulation Z implements the federal Truth in Lending Act, which is contained in Title I of the Consumer Protection Act and Section 1204 of the Competitive Equality Banking Act of 1987.

The Truth in Lending Act requires disclosure of certain costs and terms of credit including the finance charge and the annual percentage rate so that a consumer can compare the prices of credit from different sources. It also limits liability on lost or stolen credit cards. In addition, it provides consumers the right to cancel certain home-secured loans. Over the years, the Truth in Lending Act has been amended by several acts. A summary of the provisions of each of the Acts follows.

Consumer Leasing Act

The Consumer Leasing Act requires disclosure of certain costs and terms of consumer leases, so that consumers can compare the prices of leasing from different sources.

Fair Credit and Charge Card Disclosure Act

The Fair Credit and Charge Card Disclosure Act requires disclosures on (1) credit and charge cards and (2) applications and pre-approved solicitations for cards, whether issued by financial institutions, retail stores, or private companies. Information such as APRs, annual fees, and grace periods must be provided in tabular form. The Act also requires card issuers that

impose an annual fee to provide disclosures before annual renewal. In addition, card issuers that offer credit insurance must inform customers of any increase in rate or substantial decrease in coverage should the issuer decide to change insurance providers.

Fair Credit Billing Act

The Fair Credit Billing Act establishes procedures for the prompt correction of errors on open-end credit accounts. It also protects a consumer's credit rating while the consumer is settling any disputes.

Home Equity Loan Consumer Protection Act

The Home Equity Loan Consumer Protection Act requires lenders to disclose terms, rates, and conditions (APR, miscellaneous charges, payment terms, and information about variable rate features) for home equity lines of credit with the applications and before the first transaction under the home equity plan. If the disclosed terms change, the consumer can refuse to open the plan and is entitled to a refund of fees paid in connection with the application. The Act also limits the circumstances under which creditors may terminate or change the terms of a home equity plan after it is opened.

Regulation AA/Credit Practices Rule (issued under the Federal Trade Commission Act)

The Credit Practices Rule prohibits lenders from using certain remedies such as confessions of judgement; exemption waivers; wage assignments; and nonpossessory, nonpurchase money, security interests in household goods in connection with consumer credit contracts. The rule also prohibits lenders from misrepresenting a cosigner's liability and requires that lenders

provide cosigners with a notice explaining their credit obligation as a cosigner. It also prohibits the pyramiding of late charges.

Regulation CC/Expedited Funds Availability Act

The Expedited Funds Availability Act requires that all banks (including branches of FBOs), savings and loan associations, savings banks, and credit unions to make funds deposited into checking, share draft, and NOW accounts available according to specified time schedules, and to disclose their funds availability policies to their customers. The law does not require an institution to delay the customer's use of deposited funds but instead limits how long any delay may last. The regulation also establishes rules designed to speed the return of unpaid checks.

Fair Credit Reporting Act

The Fair Credit Reporting Act establishes procedures for correcting mistakes on a person's credit record and requires that a consumer's record only be provided for legitimate business needs. It also requires that the record be kept confidential. A credit record may be retained seven years for judgements, liens, suits, and other adverse information, except for bankruptcies, which may be retained ten years. If a consumer has been denied credit, a cost-free credit report may be requested within 30 days of denial.

Fair Debt Collection Practices Act

The Fair Debt Collection Practices Act is designed to eliminate abusive, deceptive, and unfair debt collection practices. It applies to third party debt collectors or those who use a name other than their own in collecting consumer debts.

Other Compliance Matters Examination Objectives

Effective date July 1997

Section 5070.2

- To determine whether the branch has policies and procedures covering applicable requirements of the Foreign Corrupt Practices Act, Federal Election Campaign Act, Bank Bribery Act, and Foreign Assets Control Regulation, and to determine the effectiveness of such procedures to ensure compliance and detect violations.
- 2. To determine if the branch has made improper or illegal payments in violation of the Foreign Corrupt Practices Act, Federal Election Campaign Act, Bank Bribery Act, or the Foreign Assets Control Regulation, and, regardless of legality, to determine whether they constitute an unsafe and unsound banking practice.
- 3. To determine if the branch is in compliance with the requirements of Regulation K and Regulation D, where applicable.
- 4. To determine if the branch has policies and procedures covering applicable requirements of the Bank Secrecy Act, and determine the effectiveness of such procedures to ensure compliance and detect violations.

- To determine if the branch has complied with the other reporting requirements regarding securities and transfer agent activities, where applicable.
- To determine if the branch has complied with reporting requirements regarding Transfer Agent, Municipal Securities Dealer, and Government Securities Broker/Dealer activities, where applicable.
- To determine if the branch has complied with the SEC's lost and stolen securities reporting and inquiry requirements, if applicable.
- To determine if branch officers and other personnel are operating in conformance with established branch guidelines.
- 9. To determine the extent and severity of violations noted, if any.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient.
- 11. To ensure that prompt corrective action is taken with respect to all violations noted.

Other Compliance Matters Examination Procedures

Effective date July 1997

Section 5070.3

- Determine whether the branch has a policy or policies prohibiting improper or illegal payments, bribes, kickbacks, or loans covered by applicable provisions of the Foreign Corrupt Practices Act, Federal Election Campaign Act, Bank Bribery Act, or Foreign Assets Control Regulation. Also, determine whether the branch has a policy addressing the requirements of the Bank Secrecy Act.
- 2. Determine whether the policy(s), if any, has been effectively communicated to officers, employees, or agents of the organization to ensure compliance.
- Review any investigation or study performed by or on behalf of the head office that evaluates policy or operations associated with the payment of funds and financial recordkeeping requirements for possible violation of the statutes mentioned above.
- 4. Review and analyze any internal or external audit program employed by the branch to determine whether the internal and external auditors have established appropriate routines to identify improper or illegal payments under the statutes. In connection with the evaluation of the adequacy of any audit program, the examiner should:
 - a. Determine whether the auditor is aware of the provisions of the Foreign Corrupt Practices Act, Federal Election Campaign Act, Bank Bribery Act, and Foreign Assets Control Regulation, and whether audit programs are in place that check for compliance with these laws.
 - b. Review such programs and the results of any audits.

- Analyze the general level of internal controls to determine whether there is sufficient protection against improper or illegal payments being irregularly recorded on the organization's books.
- Examiners should be alert, in the course of their usual examination procedures, for any transactions or the use of organization services or equipment, which might indicate a violation of the statutes.
- Determine whether the branch is in compliance with Regulation K by reviewing the activities and investments in which the branch engages.
- For the responsible Federal Reserve Bank, determine whether the FBO is in compliance with Section 211.28 of Regulation K.
- Consult with the examiner assigned "Review of Regulatory Reports" to determine if any instances of noncompliance with Regulation D have occurred.
- Review the procedures in effect regarding the filing of Form X-17F-1A (Missing, Lost, Stolen, or Counterfeit Securities Report).
- Review the procedures in effect regarding compliance with the inquiry requirements under Lost and Stolen Securities Reporting and Inquiry Requirements (17CFR 240.17 F-1).
- 12. Review manual or automated OFAC accounts and wire transfer screening systems. Ensure that periodic OFAC updates are incorporated into the monitoring system in a timely manner.

Other Compliance Matters Internal Control Questionnaire

Effective date July 1997 Section 5070.4

FOREIGN CORRUPT PRACTICES ACT

- 1. Has the branch adopted written policies that prohibit the offering or payment of improper or illegal payments, bribes, kickbacks, or loans to or from foreign government officials, officials of a foreign government instrumentality, a foreign political party or official thereof, a candidate for foreign political office, or to a person that the branch employee believes will give such money to those foreign officials?
- 2. Has this policy been communicated to all branch employees?
- 3. If an allowable payment is made, did the branch properly record the transaction without trying to conceal the activity?
- 4. Does the allowable payment consist only of a payment made to expedite or secure the performance of a routine governmental action by a foreign official, foreign political party, or foreign party official?

FEDERAL ELECTION CAMPAIGN ACT

- 5. Has the branch adopted written policies that prohibit it from making contributions or expenditures in connection with any election to any political office or to any primary election, political convention, or caucus held to select candidates for political office? Does the policy also prohibit political contributions made by providing equipment and services without charge to candidates for office?
- 6. Has this policy been communicated to all branch employees?
- 7. The statute allows the branch to establish a separate segregated fund for political purposes by a corporation, labor organization, membership organization, cooperative, or corporation without capital stock. If the branch has established such a fund, were contributions requested and obtained from employees on a strictly voluntary basis?
- 8. Are such solicitations only made a maximum of twice a year?
- 9. Are such solicitations only made to executive or administrative personnel (i.e., sala-

- ried, not hourly paid, employees who have policy making, managerial, professional, or supervisory responsibilities), employees of the branch or family members of such persons?
- 10. If an allowable contribution is made, did the branch properly record the transaction without trying to conceal the activity?

BANK BRIBERY ACT

- Has the branch adopted a code of conduct or written policy that prohibits branch officials from:
 - a. Soliciting for themselves or a third party anything of value from anyone in return for any business, service, or confidential information of the branch or the FBO, as applicable?
 - b. Accepting anything of value from anyone, whose intent is to corruptly influence or reward the branch official in connection with branch business, either before or after a transaction is discussed or consummated?
- 12. Does the code or policy describe prohibited conduct, including conflicts of interest? Does it describe appropriate exceptions, including a range of internally acceptable dollar amounts for the various benefits that the branch official may receive from those doing or seeking to do business with the branch?
- 13. Does the branch have its employees sign a written acknowledgment of having received a copy of this code or policy? Is an acknowledgment signed each time there are changes to the code or policy?
- 14. When a branch official is offered or given a gift by a customer, does the branch official prepare a disclosure statement describing such incident?
- 15. Does management regularly review the disclosure(s) to ascertain if it is reasonable?

FOREIGN ASSETS CONTROL REGULATION

16. Does the branch have a written procedure for monitoring compliance with the regulation?

- 17. Does the branch have a policy that addresses transacting business with countries against which sanctions have been imposed by the U.S.?
- 18. Does the branch refuse to transact business with those countries or specially designated nationals so listed by the statute?
- 19. Does the branch report all blockings to the Office of Foreign Assets Control (OFAC) within ten days of occurrence?
- 20. If the branch does conduct a transaction with a national from an economically sanctioned country, did the customer obtain a license from OFAC allowing it to undertake such transaction?
- 21. Does the branch's system for monitoring compliance with the statute include a continuing review of its customer country lists and customer names to ensure that it is not dealing with customers from sanctioned countries or designated nationals?
- 22. Are OFAC updates incorporated into the monitoring system in a timely manner?
- 23. Do customer files contain sufficient documentation that show the foreign citizenship or residency of the customer?
- 24. Are private banking officers or other branch personnel who solicit loans or open deposit accounts cognizant of prohibited countries under the regulation?

REGULATION K

- 25. Are the activities in which the branch engages permissible under Regulation K?
- 26. Does the branch monitor the total loans and extensions of credit extended to each single borrower?
 - a. Is this information given to the branch's U.S. regional headquarters of head office for determination of compliance with section 211.28 of Regulation K?
 - b. If this is an examination of the U.S. regional headquarters of the FBO, is the organization in compliance with section 211.28 of Regulation K?
 - c. If the branch reports directly to the head office, is documentation sufficient to support compliance with section 211.28 of Regulation K?

REGULATION D

27. Is the branch required to maintain reserves

- according to Regulation D? If so, have adequate reserves been maintained? (Refer to the Review of Regulatory Reports ICQ)
- Review the branch's system for compliance with the reporting and inquiry requirements of the lost and stolen securities provisions of 17 CFR 240.17f-1.
 - a. Has the branch registered as a direct or indirect inquirer with the Securities Information Center, Inc.?
 - b. Are reports submitted within one business day of discovery when:
 - Theft or loss of a security is believed to have occurred through criminal activity?
 - A security has been missing or lost for two business days, except in certain cases?
 - · A security is counterfeit?
 - c. Are reports submitted by the branch, as a delivering institution, within two business days of notification of nonreceipt when:
 - Delivery is made in person and no receipt is maintained by the branch?
 - Delivery of securities is made by mail or via draft and payment is not received within 10 business days and confirmation of nondelivery has been made by the receiving institution?
 - Securities are lost in transit and the certificate number(s) can be determined?
 - d. Are reports submitted by the branch, as a receiving institution, within one business day of discovery and notification of the certificate number(s) when:
 - Securities are delivered through a clearing agency and the delivering institution has supplied the certificate numbers within the required two business days after request?
 - Securities are delivered over the window and the delivering institution has a receipt and supplies the certificate number(s) within the required two business days after request?
 - e. Are securities that are considered to be lost or missing as a result of counts or verifications reported no later than ten business days after discovery or as soon after as the certificate number(s) can be ascertained?
- 29. Are copies of those reports submitted to the registered transfer agent for the issue and

- the Federal Bureau of Investigation, in the case of suspected criminal activity?
- 30. Are all recoveries of securities reported within one business day of recovery or finding? (Note: Only the institution that initially reported the security as missing can make a recovery report.)
- 31. Are inquiries made when the branch takes in any security that is not:
 - a. Received directly from the issuer or issuing agent at issuance?
 - b. Received from another reporting institution or Federal Reserve Bank in its capacity as fiscal agent?
 - c. Received from a branch customer and is registered in the name of the customer or its nominee?
- 32. Are all reports made on Form X-17F-1A or facsimile?

33. Are copies of Form X-17F-1A and subsequent confirmations and other information received maintained for three years in an easily accessible location?

CONCLUSION

- 34. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
- 35. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Asset Quality Introduction Effective date July 1997

Section 6000.1

Although a branch relies on the financial and managerial support of the FBO as a whole, the evaluation of asset quality in a branch is important in assessing the effectiveness of credit and transfer risk management¹ and in the event of a possible liquidation of a branch.

In evaluating asset quality, the examiner will assess the branch's assets and off-balance sheet exposure as of the examination date. These would include, but not be limited to: placements, investments, loans, bankers acceptances,

standby letters of credit, and loan commitments. The assessment will take into consideration (1) the level, distribution, and severity of exposure classified for credit and transfer risk, specially mentioned, or listed as Other Transfer Risk Problems, and (2) the level and composition of nonperforming and reduced rate assets.

If the FBO is in less than satisfactory condition and the branch is in a net due from affiliate position, the asset quality rating may be negatively affected.

Additional procedures for evaluating assets and off- balance sheet exposure can be found in the Risk Management section of this manual. This section of the manual discusses the classification of assets and off-balance sheet exposure.

While credit and transfer risk are identified as part of the evaluation of asset quality, the effectiveness of the branch's credit and transfer risk management are evaluated under risk management.

Effective date July 1997

According to the methodology established by their respective state or federal agency, examiners will select a sample of assets and off-balance sheet exposures (contingencies) to review in order to evaluate the credit risk exposure to the branch. The credit review includes analyzing individual credits and documenting the findings, discussing the findings with branch management, and assigning asset quality ratings to each credit based on the examiner's best judgment concerning the degree of risk inherent in the credits and the likelihood of an orderly repayment. The credit review also allows for the evaluation of the branch's internal risk rating/grading process.

This section discusses criteria used to assign asset quality ratings to extensions of credit that exhibit potential problems or well-defined weaknesses. These criteria are primarily based upon the degree of risk and likelihood of orderly repayment. Extensions of credit that exhibit potential weaknesses are categorized as special mention, while those that exhibit well-defined weaknesses and a distinct possibility of loss are categorized as classified. The term classified is subdivided into more specific subcategories ranging from least to most severe: substandard, doubtful, and loss. The weighted classified assets and contingencies ratio represents weighted classifications as a percentage of total claims on nonrelated parties plus classified contingencies, and is the standard measure of the overall asset quality ("A" ROCA component) of the branch.

In reviewing asset quality, examiners identify the amount and severity of credit and transfer risk exposures at the branch. This section discusses credit risk and provides guidelines for the classification of the FBO's loan portfolio and credit substitutes. The more severe classification, whether due to transfer risk or credit risk. takes precedence over the less severe classification. For additional guidelines on the classification of due from banks, placements, securities, other real estate owned and other assets, see those sections of this manual. For guidelines on transfer risk classification refer to the Transfer Risk section of this manual. The following section provides guidelines for the classification of the FBO's loan portfolio and credit substitutes.

ASSESSMENT OF CREDIT QUALITY

The evaluation of each extension of credit should be based upon the fundamental characteristics affecting the timely collectibility of that particular credit, including at a minimum:

- The original source of repayment and the borrower's continuing ability to utilize that source;
- The purpose of the credit relative to its source of repayment;
- The underwriting of the credit relative to its purpose, terms and structure;
- The overall financial condition and resources of the borrower, including the current and stabilized cash flow, debt service capacity, and future prospects;
- · The credit history of the borrower; and,
- The types of secondary and tertiary sources of repayment available, such as guarantor support and the collateral's value and cash flow. (The undue reliance on secondary sources of repayment should be questioned, and the branch's policy about permitting such a practice should be reviewed.)

The longer the borrower has the branch's funds or a contractual right to obtain funds, the greater the risk of some adverse development in the borrower's ability to repay the funds. Confidence in the borrower's repayment ability is usually based upon past financial performance and projections of future performance. Failure to meet projections is a credit weakness but does not necessarily mean the asset should be criticized or classified. On the other hand, the inability to generate sufficient cash flow to service the debt is a well-defined weakness that jeopardizes the repayment of the debt and, in most cases, merits classification. The extent and nature of a shortfall in the operating figures, the support afforded by assigned collateral, and/or that provided by cosigners, endorsers, or guarantors, should influence the severity of the classification.

Specially Mentioned Category

A specially mentioned extension of credit has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the credit or in the branch's credit position at some future date. Specially mentioned credits are not adversely classified and do not expose a branch to sufficient risk to warrant adverse classification. However, because specially mentioned credits can be indicative of emerging credit problems, examiners are to consider the level and trend of these credits in their analysis of the branch's assets and off-balance-sheet items.

Extensions of credit that might be detailed in this category include those where:

- · Lending officers may be unable to properly supervise the credit because of an inadequate loan or credit agreement;
- · Questions exist regarding the condition of and/or control over collateral:
- · Economic or market conditions may unfavorably affect the obligor in the future;
- · Obligor's operations may show a declining trend or an imbalanced position in the balance sheet, but not to the point that repayment is jeopardized; or
- · Deviations from other prudent lending practices are present.

The Special Mention category is not to be used to identify a credit that has as its sole weakness credit data or documentation exceptions that are not material to the repayment of the asset. It is also inappropriate to use this category to list credits that bear risks usually associated with a particular type of financing. Any type of credit, regardless of collateral, financial stability, and responsibility of the obligor, involves certain risks. For example, a loan secured by accounts receivable has a certain risk, but the risk must have increased beyond that which existed at origination to categorize the credit as special mention. A rapid increase in receivables for reasons that are unknown to the branch, concentrations that lack proper credit support, lack of on-site audits, or other similar matters could lead the examiner to question the quality of the receivables and possibly special mention the loan.

When classifying a credit, it may not be appropriate to list the entire amount under one credit quality category. This situation is commonly referred to as a "split classification" and may be appropriate in certain instances, especially when there is more certainty regarding the

collectibility of one portion of the credit than another.

Extensions of credit that exhibit well-defined credit weaknesses may warrant classification based on the description of the following three classification categories:

Substandard—A substandard credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Credits so classified must have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. They are characterized by the distinct possibility that the branch will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual credits classified substandard.

Doubtful—A credit classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or repayment in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures; capital injection; perfecting liens on additional collateral; and refinancing plans.

Examiners should avoid classifying an entire credit doubtful when collection of a specific portion seems highly probable. An example of proper utilization of the doubtful category is the case of a company being liquidated, where the trustee-in-bankruptcy has indicated a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the branch. In that situation, estimates are based on liquidation value appraisals, with asset values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful and 35 per-

Examiners should avoid repeating a doubtful classification at subsequent examinations. The time between examinations should be sufficient to resolve pending factors. That is not to say that situations do not occur to necessitate continuation of the doubtful classification. However, the examiner should avoid undue continuation if repeatedly, over the course of time, pending events do not occur and repayment is again deferred awaiting new developments.

Loss-Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Writing off a loss asset or the portion of an asset identified as loss ensures that the value of the branch's assets are properly reflected on its Report of Assets and Liabilities. A loss asset should not remain on the branch's books while it attempts a long-term recovery. Rather, losses should be taken in the period in which they surface as being uncollectible.

Branch management should maintain a record of all loss assets or the portion of assets identified as loss that have been written off for regulatory reporting purposes or for which a specific reserve has been established. Branch records should also demonstrate that these loss assets have been fully reported to the head office. For further information on the treatment of loss assets, examiners should refer to their respective agency's policy.

Partially Charged-Off Loans

Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full but that a portion of the loan may be reasonably certain of collection. When an institution has taken a charge-off or a specific reserve in an amount that is sufficient, so that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably certain of collection, classification of the remaining recorded balance may not be appropriate. For example, when the remaining recorded balance of an asset is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be classified. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than substandard.

A more severe classification than substandard for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

Formally Restructured Loans

For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms. The classification treatment previously discussed for a partially charged-off loan also would generally be appropriate for a formally restructured loan, when partial charge-offs have been taken. Troubled loans, whose terms have been restructured, should be identified in the branch's internal credit review system and closely monitored by management. Risk management of the branch should not be criticized for continuing to carry loans having weaknesses that result in classification as long as the management has a well-conceived and effective workout plan for such borrowers and effective internal controls to manage the level of these loans. This principle holds for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties.

The Role of Guarantees

The original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classi-

fication of assets. However, examiners may also consider the support provided by guarantees. The presence of a guarantee from a "financially responsible guarantor" may be sufficient to preclude or reduce the severity of classification. For purposes of this discussion, a guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit:
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and,
- The guarantee is legally enforceable.

These attributes are discussed in more depth below.

Financial Capacity of Guarantor—The branch must have sufficient information concerning the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. In addition, it is important to consider the number and amount of guarantees currently extended by a guarantor in order to determine that the guarantor has the financial capacity to fulfill all of the contingent claims that exist.

Guarantor's Willingness to Repay—Examiners normally rely on the analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar facilities. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. Examiners do not give credence to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review. Examiners also consider the economic incentives for performance from guarantors. This includes guarantors who have already partially performed under the guarantee, who

have other significant investments in the project, whose other sound projects are cross-collateralized or otherwise intertwined with the credit, or whose guarantee is collateralized by readily marketable assets that are under the control of a third party.

In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners should also consider the branch's intent to enforce the guarantee and whether there are valid reasons to preclude it from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

Guarantees issued by the head office of the branch for credits on the books of the branch lend no additional support to credits. The branch and its head office are one legal entity. Guarantees from affiliates of the foreign banking organization may offer some additional support if the affiliate is a separate legal entity. However, adequate financial information must be available to support financial capacity. Nevertheless, such affiliate guarantees do not stand entirely alone and do not offer the kind of support similar to that of a third party guarantee.

Off-Balance-Sheet Items

The principal off-balance-sheet credit transactions likely to be encountered during loan reviews are standby letters of credit (SBLCs), and loan commitments. When evaluating off-balance-sheet credit transactions for potential classification or special mention, careful consideration should be given as to whether the branch is irrevocably committed to advance additional funds under the credit agreement. If the branch must continue to fund the commitment and a

potential weakness exists that if left uncorrected may at some future date result in the deterioration of repayment prospects or the branch's credit position, the amount of the commitment may be categorized as special mention. If there is a well-defined weakness that jeopardizes repayment of a commitment, classification may be warranted.

For credit analysis purposes, SBLCs should be treated as if they were loans to the account parties. They are considered one type of instrument that a customer can use under the overall credit line that has been extended by the branch. In most cases, particularly with respect to credit enhancement-type SBLCs, the examiner will classify the SBLC if it is determined that the account party will need to draw on the SBLC. In such cases, the account party, having been financially unable to meet its underlying commitment, probably may not be able to reimburse the branch for making payment on the SBLC. The same holds true for commitments to issue SBLCs. If the branch has an unrevocable commitment to issue a SBLC and it is determined that the account party will need to draw on the SBLC, examiners will classify the commitment.

In the case of loan commitments, credit risk stems from the possibility that the creditworthiness of the customer will deteriorate between the time the commitment is made and the funds are advanced.

Refer to the Off-Balance Sheet-Activities and Letters of Credit sections of this manual for additional information on off-balance-sheet items.

Guidelines for Special Mention and Classified Credit Comments

An examiner must present, in written form, well-supported comments relating to assets and contingencies subject to classification or special mention. Write-ups are mandatory when branch management disagrees with the examiner's assessment. Examiners should consult with their respective agency for guidance on when other write-ups are required. A thorough understanding of all factors surrounding the credit is required, so that only those germane to the credit's collectibility are included. When portions of the line are assigned different classifications or are not classified, the comments should clearly set forth the reason for such split treatment.

Before a write-up is prepared, the examiner should recheck central liability files or other sources at the branch to determine that all credits to the borrower have been noted and included. Consideration should be given to the classification of accrued interest receivable. Classification is suggested when the cumulative effect on classified percentages is significant or the accrued interest is appropriately classified loss. (See the Credit Risk Management section of this manual for a discussion of nonaccrual status and the reversal of accrued interest for loans when nonaccrual status is appropriate).

When financial institutions engage in international lending, they undertake customary credit risk, or the possibility of nonpayment due to an obligor's weak financial condition or a lack of adequate collateral protection. International lending also leads to country risk, which encompasses the entire spectrum of risks arising from the economic, political, and social trends and movements in a foreign borrower's home country.

International lenders, in particular, bear the risk that a foreign borrower will be unable to convert its local currency income into the currency needed to repay the loan (i.e., transfer risk). Transfer risk therefore, focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt. Because branches are typically oriented toward financing international trade and business, transfer risk can be a significant consideration in evaluating a branch, more so than at other types of financial institutions. Irrespective of its significance, the criteria and guidelines for evaluating transfer risk exposures at branches are similar to those at other U.S. financial institutions.

TRANSFER RISK CRITERIA

In 1979, the federal regulatory agencies adopted uniform examination procedures for evaluating and commenting on country risk factors resulting from international lending by banks in the United States. Under this system, examiners segregate country risk factors from the evaluation of other lending risks. In December 1983, the federal banking agencies, through the Interagency Country Exposure Review Committee (ICERC), further adopted examination categories for identifying credits that have been adversely affected by transfer risk problems. These categories include classified credits, i.e., Substandard, Value Impaired, and Loss; Other Transfer Risk Problems (OTRP); and Exposures Warranting Special Comment (EWSC). The examination of transfer risk entails identifying and reporting transfer risk credits according to these categories. To maintain uniformity of examination approach, examiners are not free to deviate from these guidelines or assign transfer risk designations other than as specified by ICERC.

The criteria for these transfer risk categories are as follows:

Substandard

Either, the country is not complying with its external service obligations as evidenced by arrearages, forced restructuring, or rollovers and, the country is not in the process of adopting an IMF or other suitable economic adjustment program or is not adequately adhering to such a program; or the country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

Value Impaired

The country has protracted arrearages as indicated by more than one of the following:

- The country has not fully paid its interest for six months:
- The country has not complied with IMF programs (and there is no immediate prospect for compliance);
- The country has not met rescheduling terms for over one year; and
- The country shows no definite prospects for an orderly restoration of debt service in the near future.

Loss

A loss classification applies when the credit is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example of such an asset is a loan to a country that has made an outright statement repudiating obligations to banks, the IMF, or other lenders.

Other Transfer Risk Problems (OTRP)

The OTRP designation is used to highlight all or a portion of those credits to:

 A country that is not complying with its external debt service obligations but is taking 6020.1 Transfer Risk

positive steps to restore debt service through economic adjustment measures, generally as part of an IMF program;

- A country that is meeting debt obligations but noncompliance seems imminent; or
- A country that has been classified previously, but recent debt service performance indicates classification is no longer warranted. However, sustained resumption of orderly debt service needs to be demonstrated.

Exposures Warranting Special Comment

EWSC categorizations are Strong, Moderately Strong, and Weak. A Strong country does not experience social, economic, or political problems that could interrupt external debt repayment. Moderately Strong countries experience a limited number of identifiable economic, social, or political problems that do not presently threaten orderly external debt repayment. A Weak country experiences many economic, social, or political problems. If not reversed, these problems could threaten orderly external debt repayment.

Other Definitions

The ICERC committee generally accords a more favorable examination treatment to performing trade credits and performing bank credits. In this context, *performing* generally means that the credit is paying down in accordance with the existing terms of the indebtedness.

Trade transactions generally include the short-term financing of the importation or exportation of goods/services between parties in two countries.

So called pre-export financing transactions require close review as they may in fact be working capital advances. There must be a connection between the branch's financing and the import or export of goods (self-liquidating transactions) to be considered as a trade transaction.

Performing bank generally includes all extensions of credit to banks which are current.

Short-term loans generally have a maturity of one year or less.

Long-term loans exceed one year in tenor.

In assessing exposure by country, adjustments to determine net exposure are made for guarantees and collateral. Risk is transferred from the country of borrower's domicile to the country the guarantor or collateral resides or is held.

Guarantees consist of those claims of the reporting institution to which a third party or affiliate formally and legally obligates itself to repay the reporting institution's claims on the direct obligor if the latter fails to do so. Documents such as comfort letters, letters of awareness, or letters of intent that do not establish firm legal obligations are not considered guarantees for the purpose of transferring country risk. Guarantees cover the collateralization of claims if the collateral or the guarantors' source of funds is both (1) tangible and liquid including readily marketable shares of stocks or bonds and (2) is held and realizable outside of the country of the domicile of the borrower. In cases involving collateral, the domocile of the guaranteeing party is the country in which the collateral is held, unless the collateral is stocks or bonds in which case it is the country of domicile of the party issuing the security.

Transfer Risk Examination Objectives

Effective date July 1997

Section 6020.2

- To evaluate the branch's country exposure risk management system. To determine if the branch's policies, practices, procedures and internal controls regarding the management of transfer risk are adequate.
- 2. To determine if the branch is operating in conformance with established guidelines.
- To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulation have been noted.
- To evaluate the branch's portfolio in order to determine the appropriate ICERC treatment ranging from loss to strong.

- To determine the effect of total transfer risk classifications and OTRP listings on overall asset quality.
- To determine the accuracy of the branch's transfer risk exposure reporting to senior branch and head office management.
- 7. To determine if the branch is properly preparing the Country Exposure Report (FFIEC 019), which is required to be filed quarterly with its district Reserve Bank.

Effective date July 1997

In reviewing asset quality, examiners identify the amount and severity of transfer risk exposures at the branch. Examiners should begin this review by first evaluating all transfer risk credits for credit risk. The more severe classification, whether due to transfer risk or credit risk, takes precedence over the less severe classification. If the classifications are the same, the credit risk designation takes precedence over the transfer risk designation. Duplications should be avoided.

In some instances, particularly where additional collateral has been pledged, the focus of the risk may change and the transfer risk classifications may not be appropriate. Classifications may also differ based on the type of exposure, e.g., performing bank and trade credits are generally less severely categorized than short- and/or long-term loans.

Information concerning the relative grouping and classification of countries and appropriate comments prepared by ICERC is furnished to examiners as required in the examination process. In turn, examiners should discuss with branch management only those ICERC designations for which the branch has actual exposure on its books. Because this information is sensitive in nature, adequate safeguards should be taken to ensure that it is not accessible to unauthorized personnel. In no event should the complete listing of ICERC designations be divulged.

As mentioned earlier, transfer risk categorizations should be strictly followed; examiners may not deviate from the transfer risk assessments as designated by ICERC. For exposures to countries that are not reviewed by ICERC, examiners should evaluate the exposures from a credit risk standpoint only. In no instance should the examiner assign transfer risk assessments for countries not rated by ICERC or use the prior rating of a country before it was dropped from review by ICERC.

CONTINGENT LIABILITIES

In view of the variance in risk of different off-balance-sheet instruments, contingent liabil-

ity claims on countries, which are treated as Value Impaired, Substandard, or OTRP, should be reviewed on a case-by-case basis. Because the likelihood of funding even legally-binding agreements is greatly diminished, the exposure is listed but not classified. As a result, except when determined with reasonable certainty that an indirect exposure will require funding, these items generally will be treated as OTRP. However, for those countries considered Loss for transfer risk purposes, performing bank and performing trade credits should be classified as Substandard.

PLACEMENT AND DISCUSSION IN THE EXAMINATION REPORT

In the examination report, transfer risk exposures are reported and discussed separately from commercial credit risk exposures. For this purpose, separate report pages, i.e., Transfer Risk and Items Subject to Classification and Items Listed for Special Mention, have been created for credits subject to classification or comment. The Transfer Risk page should contain a listing, by country, of exposures subject to classification as a result of transfer risk considerations and of exposures listed as OTRP.2 For each country, examiners should provide commentary on each exposure classified for transfer risk or listed as OTRP. The examiner's commentary should be followed by the supporting write-ups prepared by ICERC on each country.

After identifying the amount and severity of transfer risk exposure(s) at the branch, this information is summarized on the Comparative Asset Quality Data examination report page (along with any credit risk classifications) and discussed on the Asset Quality page. In those

^{1.} Countries are selected for review by ICERC based on the amount of total exposure outstanding to U.S. financial institutions

^{2.} While not subject to classification, significant OTRP exposures should be considered by examiners as a judgmental factor in their general assessment of a branch's asset quality. This approach is similar to the consideration given to such factors as concentrations in the portfolio, including, for example, the level and composition of nonaccruing or reduced rate assets and concentrations to countries rated as EWSC. In this regard, exposures categorized as EWSC, if material, can be mentioned in the report or listed on the Concentrations page.

instances where the branch has other exposures of concern, which warrant special attention by branch and head office management, comments in this respect should be included on the Asset Quality page. As discussed in the ROCA rating system, any comments relating to how the branch manages its transfer risk exposure should be discussed on the Risk Management page. Comments along these lines may relate to the effectiveness of the branch's country exposure reporting systems. Transfer risk classifications of any significance should be highlighted on the Examination Conclusions and Comments page.

CONCENTRATIONS

Certain U.S. branches may engage heavily in financing international business and trade from their home countries or geographic regions. As measured in terms of their total net assets, these branches may thus have significant concentrations to those countries or regions, which should be listed on the Concentrations page. However, the degree to which these exposures pose any risk to the branch itself, and thus are commented on in the report of examination, is dependent upon a number of considerations, such as the overall composition of the branch's portfolio; the branch's business plan; the effectiveness of the branch's risk management techniques, including its country risk reporting systems; and the strength-of-support assessment of the foreign banking organization. Whether or not concentrations are worthy of comment, examiners should ensure that all such exposures are within the branch's internal policy limits and are monitored and periodically reported to the head office.

COUNTRY EXPOSURE REPORT (FFIEC 019)

Examiners are encouraged to review the Instructions for Preparing the Country Exposure Report. Examiners are not expected to review the Country Exposure Reports filed between examinations for accuracy; however, examiners should conduct a spot check of the most recent report to verify that the reports are being prepared accurately. Material reporting errors uncovered during the examination should initially be noted on the Compliance page in the report of examina-

tion. In those instances where branch and head office management rely on the data generated for the Country Exposure Report and reporting exceptions are noted, comments should be incorporated on the Operational Controls page.

RESERVING REQUIREMENTS

The regulations requiring banking institutions to establish special reserves, i.e., an allocated transfer risk reserve or ATRR, against the risks presented in certain international assets³ are *not* applicable to branches of FBOs (Regulation K, Section 211.42). However, branches are expected to have policies in place for recognizing loss assets or writing down assets that are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. In many instances, these policies stem from home country regulations that are in place for the FBO as a whole.

Separately, examiners should evaluate the amount of transfer risk inherent in a branch's assets in the same manner as for other banking institutions. If applicable, for assets that are classified Value Impaired, any amount on the books above the required ATRR percentage is weighted at 100 percent; the residual amount is weighted at the same percentage as assets classified Substandard, or 20 percent.

COUNTRY EXPOSURE RISK MANAGEMENT SYSTEM

As part of its overall risk management techniques, branch management should have in place a country exposure risk management system, which has been developed, in conjunction with, and approved by head office management. Examiners should evaluate the effectiveness of the system to monitor and control the branch's country exposure by verifying adherence to country suballocation limits and accurate reporting of country exposures submitted on the FFIEC 019. The evaluation should include a review of the exposures for at least several countries. Material exceptions may be subject to comment on the Risk Management page in the report of examination.

^{3.} Those assets included on the FFIEC 019.

The following procedures should be used by examiners in evaluating systems employed by branches to monitor and control country risk elements in international loan portfolios:

- Review the branch's written policies covering transfer risk and the name, composition, and location of the committee responsible for administration of transfer risk.
- 2. Review policies and:
 - Determine who initiates and who gives final approval of country ratings and country limits.
 - Determine how frequently, and by whom, country ratings and limits are reviewed and changed.
 - c. Determine how the bank defines the ratings assigned to the various countries.
 - d. Ascertain how country limits are determined.
 - e. Determine who is responsible for monitoring compliance with country limits.
 - f. Determine to what extent country limits are viewed as guidelines which may be exceeded.
 - g. Determine if the branch has different sublimits for private and public sector credits.
 - h. Determine if the head office or a committee periodically reviews country ratings and limits, and evaluates the branch's performance against those standards.
 - Determine how the system has been changed since the previous examination.
- Review reports furnished to the head office or appropriate committee to assure that comprehensive and accurate information is being submitted on a timely basis.

4. Determine whether the branch is in compliance with its country exposure limits.

In preparing the risk management analysis examiners should consider factors such as:

- The quality of policies, practices, procedures and controls over the country exposure management area.
- The scope and adequacy of the internal loan review system as it pertains to country exposure.
- Causes of existing problems, if any.
- Commitments from branch management for correction of deficiencies.
- Expectations for continued sound international lending or correction of existing deficiencies.
- The ability of branch management to monitor and control transfer risk.
- The general level of adherence to internal policies, practices, procedures and controls.
- The scope and adequacy of the branch's analysis of country conditions if the branch has responsibility for it.

LDC DEBT

The crisis in the 1980s surrounding third world debt spawned a trading market for Less Developed Country (LDC) debt. The examiner may refer to the Federal Reserve's Trading Activities Manual for further guidance concerning the review of LDC debt trading.

Transfer Risk Internal Control Questionnaire

Effective date July 1997

Section 6020.4

- Has the head office adopted policies and limits for all non-U.S. on- and off-balancesheet exposure that:
 - a. Establish country exposure limits for all activities?
 - b. Establish limits for distribution of assets and off-balance sheet exposure by type and maturity?
 - c. Acknowledge concentrations of exposure within countries?
- 2. Are policies and limits reviewed at least annually to determine if they are compatible with changing market conditions?
- 3. Are country limits revised in response to substantive changes in economic, political, and social conditions within particular countries?

- 4. Prior to granting additional advances or commitments, are outstandings checked to appropriate country limits?
- 5. Are lending officers cognizant of specific country limitations?
- 6. Are procedures for exceeding country limits clearly defined?
- 7. Does the scope of the branch's asset quality review ensure that international risk assets outstanding and committed are within the branch's foreign exposure limits?
- 8. Does the branch have a formal reporting system on country risk?
- 9. Does the reporting system provide complete risk exposure data readily and in sufficient detail?

The International Banking Act (IBA) of 1978 amended the Federal Deposit Insurance Act and allowed the U.S. branches of foreign banks to apply for deposit insurance. Part 346 of the FDIC's Rules and Regulations and Section 28.8 of the Comptroller's Regulations implement the statute. Deposit insurance remained voluntary for branches engaged solely in wholesale banking, but a branch with a domestic retail banking activity had to obtain deposit insurance. Domestic retail banking was defined as the acceptance of initial deposits under \$100,000. Exemptions were permitted to allow branches conducting incidental retail banking to avoid having to obtain deposit insurance. In addition, a foreign bank could insure one or more of its U.S. branches, but elect not to insure others. Edge Act and Agreement Corporations and U.S. agencies of foreign banks could not obtain coverage.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended the IBA to disallow a de novo U.S. branch of a foreign bank from obtaining deposit insurance if it is engaged in retail banking activity. Already existing insured branches were permitted to retain their FDIC insurance. A foreign bank seeking to engage in retail banking activities in the United States is now expected to establish an insured subsidiary bank.

This chapter has two goals:

- To aid examiners at uninsured branches in determining that a branch is operating solely as a wholesale bank or, if some retail deposits are being accepted, that the office is operating within permissible exceptions.
- To aid examiners at insured branches in determining that the branch is meeting recordkeeping, pledge, and asset maintenance requirements.

Because the requirements for uninsured branches differ from those for insured branches, the overview, examination objectives, and examination procedures will be described separately.

UNINSURED BRANCHES

In the case of state-licensed branches, the branch is subject to restrictions on the acceptance of deposits that the appropriate state licensing authority has determined, by regulation or order, do not constitute engaging in domestic retail deposit activities requiring deposit insurance protection. State licensing authorities may have similar requirements and exceptions as Part 346.4 of the FDIC's Rules and Regulations. However, examiners must determine that a branch engaging in some retail deposit activity conforms to the exemptions allowed under local State law.

Part 346.4 of the FDIC's Rules and Regulations states that a foreign bank may not operate a U.S. branch if the branch is uninsured and is engaged in domestic retail deposit activity (accepting an initial deposit of less than \$100,000), and is located in a state that requires banks to have deposit insurance. Two exceptions are permitted: (1) Part 346.5 permits branches established under Section 5 of the International Banking Act to accept only those deposits as permitted to an Edge Act Corporation under Section 25(a) of the Federal Reserve Act, and (2) Part 346.6 permits branches to engage in certain retail deposit activities that do not trigger a requirement for deposit insurance. Uninsured branches may accept initial deposits of less than \$100,000 from the following type of depositors or resultant activity:

- Any for-profit business entity;
- Any domestic or foreign government entity or agency;
- Any international organization of two or more nations;
- Any funds received for transmission elsewhere; and,
- Any nonresident alien at the time of the initial deposit.

In addition, the branch is permitted to accept other deposits under a *de minimis* rule. The total of such deposits shall not exceed 5 percent of the average of the branch's deposits from unrelated third parties for the last 30 days of the most recent calendar quarter. Moreover, the branch may not solicit or advertise for deposits from the general public. For state-licensed branches, the state licensing authority may have different *de minimis* rules and additional disclosure requirements.

A foreign bank may apply to the FDIC to operate a branch that engages in domestic retail

deposit activity not otherwise included above. An uninsured branch operating under Part 346.6 exemptions must notify depositors that it is an uninsured office. Conversely, an uninsured branch that is not operating under Part 346.6 exceptions need not notify depositors that their deposits are uninsured. Where required, notification must include signs at teller windows and other locations where deposits are accepted stating that deposits are not insured by the FDIC. Also, each signature card, passbook, and instrument evidencing a deposit must include a bold face statement as follows: "This deposit is not insured by the FDIC." These acknowledgments must be retained by the branch as long as the depositor maintains any deposit at the branch. Since 1989, the requirements for acknowledgments and their retention have included negotiable certificates of deposit.

INSURED BRANCHES

Insured branches have specific FDIC asset maintenance and asset pledge requirements that are apart from any other asset maintenance, pledge, or capital requirements of the federal or state licensing authorities. In addition, the FDIC requires the insured branch or group of insured branches in a state to keep records and sets of accounts in the English language that accurately reflect the business transactions of the branch on a daily basis. These records must be kept as though the branch were a separate entity with its assets and liabilities separate from the operations of the head office and other branches, agencies, subsidiaries, or affiliates of the foreign bank. The FDIC's requirements are intended to protect the insurance fund from losses in the event the branch must be liquidated and, as such, it is important that examination staff, regardless of agency, pay close attention to the insured branch's compliance with these requirements. For additional information, refer to the Asset Maintenance section of this manual.

Pledge of Assets

Part 346.19 of the FDIC's Rules and Regulations implements the pledged assets requirements for insured branches. The intent of the pledge requirement is to have highly marketable assets available to protect the fund in the event the FDIC must pay the branch's insured depositors. The size of the pledge is normally five percent of the branch's average liabilities for the last 30 days of the second and fourth calendar quarters. The pledged assets must be placed at a depository approved by the FDIC.

Part 346.19(d) describes the eight types of assets that may be pledged. At the end of the second and fourth quarters, both the depository and the insured branch must file reports with the regional FDIC office listing and describing in detail the assets pledged. In addition, the insured branch must report the average of the branch's liabilities for the last thirty days of the respective quarter; the average is used to determine the size of the pledge requirement. The branch may substitute one pledged asset for another between reporting dates. Such substitutions normally do not have to be reported to the FDIC, but must be of the type allowed by Part 346.19(d).

Asset Maintenance

Asset maintenance is the method used by the FDIC to ensure that foreign bank resources are retained in the branch. Part 346.20 of the FDIC's Rules and Regulations sets forth the required amount of asset maintenance and the assets eligible for inclusion in the asset maintenance computation.

An insured branch normally must have eligible assets in an amount not less than 106% of the preceding quarter's average liabilities. Branches are permitted flexibility in that they may compute the ratio either on a daily basis or the Wednesday of each week. In some instances the branch may be required to maintain the 106% ratio on a daily basis. In other instances, the percentage requirement may be higher.

The effectiveness of the asset maintenance requirement depends on limiting eligible assets to those that meet minimum quality standards and are free from impediments to collectibility in the event the FDIC needs to take possession of the assets. Part 346.20(b) lists six classes of assets that are excluded from use as eligible assets:

- · Any asset due from the bank's other offices or
- · Any asset classified Value Impaired, to the extent of the required Allocated Transfer Risk Reserves or equivalent write down, or Loss in

- the most recent state or federal examination report:
- Any deposit of the branch with a bank, unless the bank has signed a waiver of offset agreement;
- Any asset not supported by sufficient credit information to allow a review of the asset's credit quality as determined at the most recent state or federal examination;
- Any asset not in the branch's actual possession unless the branch holds title to such asset and the branch maintains records sufficient to enable independent verification of the branch's ownership of the asset as determined at the most recent state or federal examination; and,
- Any intangible asset.

Federal Deposit Insurance—Uninsured and Insured Branches **Examination Objectives Section 7010.2**

Effective date July 1997

UNINSURED BRANCHES

INSURED BRANCHES

- 1. To determine if policies, practices, procedures, and internal controls regarding notification procedures for uninsured branches are adequate.
- 2. To determine if branch employees are operating in conformance with the established guidelines.
- 3. To determine the scope and adequacy of the audit function.
- 4. To determine compliance with Part 346 and any applicable state laws.
- 5. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of applicable laws or regulations have been noted.

- 6. To determine if policies, practices, procedures, and internal controls regarding asset pledge requirements and asset maintenance requirements are adequate.
- 7. To determine if branch employees are operating in conformance with established guidelines.
- 8. To determine the scope and adequacy of the audit function.
- 9. To determine compliance with applicable laws and regulations.
- 10. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of applicable laws or regulations have been noted.

Federal Deposit Insurance—Uninsured and Insured Branches Examination Procedures

Effective date July 1997

Section 7010.3

UNINSURED BRANCHES

- 1. Determine the adequacy of the internal audit procedures used to check compliance with Parts 346.4, 346.5, 346.6, and 346.7, and with any applicable state laws.
- Review audit procedures used to check compliance with Part 346 and with any applicable state laws. Obtain a list of any deficiencies noted in the latest review performed by the internal auditors, and determine if corrections have been made.
- 3. For a branch operating without Part 346.6 exemptions, determine the adequacy of the branch's procedures that ensure that it has no domestic retail deposit activity. Review deposit ledgers to ascertain that the branch has not been engaging in domestic retail deposit activity.
- 4. Determine the adequacy of the branch's procedures that ensure that a branch engaging in some retail deposit activity is conforming to the exemptions allowed in Part 346.6 and in state law. In this case, verify that:
 - a. The branch is confining its retail deposit activity to the six permitted exemptions.
 - b. The branch is displaying conspicuously signs at windows or places where deposits are accepted that deposits are not insured by the FDIC.
 - c. The branch's signature cards, passbooks, and other instruments evidencing a deposit have in bold face the following statement: "This deposit is not insured by the FDIC."
 - d. The branch requires each depositor to execute a statement that acknowledges that the initial and all future deposits are not insured by the FDIC (if the branch is not using notification statements on its signature cards, passbooks, and other instruments evidencing deposits).
- 5. Where required notification statements are not made in signature cards, passbooks, and other instruments evidencing deposits, ascertain that depositor acknowledgments are obtained showing that deposits are uninsured.

- applicable regulations. Obtain a list of any deficiencies noted in the latest review performed by the internal auditors and determine if corrections have been accomplished.
- 7. Ascertain the adequacy of the branch's procedures that ensure that:
 - a. The semiannual reports of pledged assets made to the FDIC's regional directors are prepared correctly, including the amount representing average liabilities for the 30 calendar days of the second and fourth quarters per Part 346.19 of the FDIC's Rules and Regulations.
 - b. The branch is maintaining on a daily basis eligible assets in an amount not less than 106% of the preceding quarter's average book value of the branch's liabilities per Part 346.20.
 - c. The branch is pledging additional assets complying with higher asset maintenance requirements or more frequent calculations of the asset maintenance ratio where directed by the FDIC.
 - d. The computations of eligible assets exclude those assets listed in Part 346.20(b). All banks holding deposits of the branch have signed waiver of offset agreements.
 - e. The calculation of average book value of the branch's liabilities does not exclude liabilities to less than wholly owned subsidiaries of the foreign bank which are not wholly owned.
 - f. The branch's workpapers adequately support the calculations of eligible assets and average book value of the branch's liabilities.

Insured branches are also subject to the requirements of Section 38 of the Federal Deposit Insurance Act and Part 325 of the FDIC Rules and Regulations, which require the branch to undertake prompt corrective action where it has failed to maintain required pledged assets and eligible assets pursuant to Part 346.

INSURED BRANCHES

6. Determine the adequacy of the internal audit procedures used to check compliance with

SUBSEQUENT EVENTS

As a practical matter, the examination is conducted and the report of examination is prepared as of a stated date. However, events or transactions sometimes occur subsequent to the date of examination (or the on-site date as of which various examination procedures were performed) but before the date the report of examination is mailed that may have a significant effect on the evaluation of a branch. Such events and transactions are referred to as subsequent events and may be of two types.

One type includes those events or transactions that provide additional evidence about conditions that existed at the examination date. Examples of this type are the bankruptcy of a significant borrower or the resolution of outstanding litigation.

The second type includes those events that provide evidence about conditions that did not exist at the date of examination. Examples of that type of event would be new litigation arising subsequent to the examination date but before mailing the examination report or a merger agreement signed subsequent to the examination date.

All information that could materially affect the evaluation of the branch and becomes available before mailing of the report of examination should be considered by the examiner in his or her evaluation of the branch. Accordingly, all events or transactions that either significantly affect or have the potential to significantly affect the evaluation of the branch should be reflected in the report of examination, regardless of whether they occurred before or subsequent to the examination date.

LITIGATION AND OTHER LEGAL MATTERS

Events or conditions arising from litigation, claims, and assessments are matters within the

direct knowledge and often control of branch management. Accordingly, management is the primary source of information about such matters. Examiners ordinarily do not possess legal skills and, therefore, should not make legal judgments on such information. The examiner should ask the branch's management for information concerning litigation, claims, and assessments. If necessary, management may send a letter of inquiry to its general counsel and to other counsel engaged to address more limited matters.

Information provided by management should include information about litigation, impending litigation, claims, and contingent liabilities. For the purpose of these requests, the terms, impending litigation, and contingent liabilities have the following meanings:

Impending litigation—litigation threatened against the branch by a third party but not formally commenced.

Contingent liabilities—matters other than litigation or claims for which available information indicates a reasonable possibility of impairing assets or increasing liabilities. Contingent liabilities should include unasserted claims or assessments.

Information provided by management should be as of the examination date and, if applicable, as of the date of counsel's response. Any responses provided by counsel should be as close to the completion of the examination as practicable to allow sufficient time for a thorough response and any follow-up, if necessary.

Subsequent Events, Litigation, and Other Legal Matters Examination Objectives

Effective date July 1997 Section 7020.2

- To determine whether any events or transactions have occurred subsequent to the examination date that have had or may have a significant impact on the present or future soundness of the branch or the conclusions expressed in the report of examination.
- 2. To determine the effect of legal counsel's evaluation of litigation, impending litigation, claims, and contingent liabilities on the examiner's overall conclusion regarding the soundness of the branch.

Subsequent Events, Litigation, and Other Legal Matters Examination Procedures

Effective date July 1997

Section 7020.3

- Obtain from the branch officer responsible for legal matters a listing of impending or threatened litigation, including follow-up information on litigation pending at the previous examination. For each item, the following information should be included:
 - a. Nature of the litigation.
 - b. Progress of case to date.
 - c. How management is responding or intends to respond to the litigation.
 - d. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss, and whether any reserves have been established for any potential loss exposure.
- 2. Obtain from the branch officer responsible for legal matters a listing of unasserted claims or assessments that management believes will probably be asserted and which, if asserted, would have at least a reasonable possibility of an unfavorable outcome. For each item, the following information should be included:
 - a. Nature of the matter.
 - b. How management intends to respond if the claim is asserted.
 - c. Possible exposure if the claim is asserted.
- 3. Obtain from management, a listing of attorneys and legal firms to whom litigation and related matters have been referred. In addition, review a listing of any litigation noted in the most recent internal and external audits, if applicable.
- Evaluate management's listing of litigation, unasserted claims and assessments, and counsel's replies, if applicable, for the potential effect on the branch.
- Discuss with appropriate branch management, the following:
 - a. Changes in credit lines or transactions with officers, related offices, and affiliates.
 - b. Changes in significant accounting and management reporting policies.

- c. Changes in senior officers.
- d. Any event or combination of events that have had or could have a material adverse effect on the branch, such as the default of a bond issue in which the branch has substantial holdings or the filing of bankruptcy by a major borrower.
- New or discontinued services not requiring prior approval.
- f. Execution of significant contracts, such as for employment, leases, pensions, or other fringe benefit programs.
- g. Significant new contingent liabilities or commitments other than those referred to above.
- h. Significant changes in assets such as a shift in the amount of loans or investments in special categories or unusual adjustments made after the date of the financial statements reviewed at the examination.
- 6. Read minutes of all meetings of appropriate committees (investment, loans, etc.) and
 - Verify with branch management whether minutes of all such meetings subsequent to the examination date are available for review.
 - b. For any meetings for which minutes have not yet been prepared, contact appropriate branch personnel about what transpired at the meetings.
- 7. If specific violations of law or areas of weakness have been reported to management earlier in the examination, determine the extent to which management has proceeded toward corrective action.
- 8. If, after completing the foregoing procedures, information is obtained that is deemed to have a significant impact on the evaluation of the branch, discuss with the examiner-incharge to determine appropriate follow-up procedures, including the preparation of comments for the examination report and workpaper documentation.

Survey of Foreign Regulation in Selected States Section 7030.1

The following table prepared by the Conference of State Bank Supervisors provides statutory and regulatory citations for selected states on a number of issues that may arise in connection with examinations of state-licensed branches and agencies in those states. It is intended to serve as a preliminary reference only; specific questions should be directed to the appropriate state banking authority or qualified legal counsel.

ente		CA	CT	FL	GA	IL	NY	TX	WA
, -	Other Real Estate Owned	FCS ¹ 750(c) ²	No specific statue or regulation.	Subsection 658.67(9)	Section 7-1- 263 OCGA	205 ILCS 5/5(9), Rule (Title 38/ Chapter II/Part 354)	N/A.	TBA ⁴ Section 9.002, 5.002 and 5.203; 7 TAC ⁵ 12.91; PM ⁶ 1008	RCW ⁷ 30.42.160(3)
P	Debts reviously Contracted	FCS 750(b) and 1234	No specific statue or regulation.	See above.	7-1-650(9) OCGA	Rule (Title 38/Chapter II/Part 554)	N/A.	TBA Section 9.002	RCW 30.42.155(G)
	teal Estate Appraisals	No state regulations.	C.G.S. Section 36a-261	Section 655.60 FS & Rule 3C- 100.600	No specific state law; FDIC Pt 323 is used by the state.	No state regulations.	N/A.	TBA Section 9.002; 7 TAC 12.91	RCW 30.42.105
	nternal and external Audits	No state regulations.	No specific statue or regulation.	Subsection 663.09(2) FS; Rule 3C- 15.012 FAC	7-1-487 OCGA	N/A.	N/A. Part 5 pending.	N/A.	Not required by statute or regulation.
B & L	ank Secrecy Money aundering	Penal Code Sections ¶14160– ¶14167	C.G.S. Part XXIII of Chap- ter 952	Section 655.50 FS; Rule 3C- 15.012 FAC; Rule 3C-1.022 FAC	7-1-911; 7-1- 912; 7-1-914; 7-1-915; 7-1- 916 OCGA	No state regulations.	No State regulations.	N/A.	Federal regulations apply for branch/agency.
L	Franch/Agency icensing rocedures	FCS 1700- 1711, 1725, 1726, 1750- 1753; CCRS ⁸ 10.11700- 10.14188	C.G.S. Section 36a-428a	Sections 663.04 FS; 663.05 FS; 663.55 FS; Chapter 3C-9 FAC	7-1-713; 7-1- 914; 7-1-915; 7-1-916 OCGA	205 ILCS 645/3- 205 ILCS 645/9	SP ⁹ FB 101; BL ³ Section 201	TBA Section 9.003, 9.004, 9.005 and 9.007; 7 TAC 3.41	RCW 30.42.060; 30.42.090 and WAC ¹⁰ 50-32

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	CA	CT	FL	GA	IL	NY	TX	WA
Branch/Agency Closing or Termination Procedures	FCS 1729, 1763, 1775– 1785	C.G.S. Section 36a-428j, 36a- 428k, 36a- 145(f) and Part VIII of Chapter 664c	Sections 663.11 FS; 663.06 FS; 658.80–658.84 FS; 658.90 FS; 658.94–658.96 FS; Rule 3C- 15.016 FAC	7-1-720 OCGA	205 ILCS 645/19	BL Sections 40; 206; 605 (11); 606 (4)	TBA Section 9.009, 9.010 and 9.001	RCW 30.42.300
International Banking Facilities	No state regulations.	No specific statue or regulation.	Section 655.071 FS; Rule 3C- 15.011 FAC; Chapter 3C-17 FAC	7-1-721 and 7- 1-732 OCGA	35 ILCS 5/30(2)	GRBB ¹¹ Part 19	N/A.	Permitted under FRB regulations.
Deposit Taking	FCS 1700(e), 1700(n), 1700(s), 1700(u), 1728, 1755, 1758, CCRS 10.14750– 10.15627	C.G.S. Section 36a-428b	Section 663.011 FS; Rule 3C 15.003 FAC	7-1-716(e) OCGA	205 ILCS 645/3	BL Section 202-a; SR ¹² Part 323	TBA 9.012	RCW 30.42.115 (branch only).
Legal Lending Limits	FCS 12211	C.G.S. Section 36a-262	Sections 663.083 FS; 658.48, 658.67, 658.49, 658.491, 658.51 FS, Rule 3C- 15.003 FAC	7-1-718(b) and 7-1-285 OCGA	No limits ¹³	BL Sections 103; 202-f	TBA Section 9.002 and 5.203	RCW 30.42.105, 30.04.111

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WA

RCW 30.42.105 (Branch); RCW

30.42.180

(Agency)

		and 30-200	Rule 3C- 15.003 FAC					(Agency)
Ineligible Assets	See next item.	Promulgation of regulations in progress.	Subsections 663.07(5) & (6)	No state regulation.	205 ILCS 645/13	SR Part 322	N/A.	RCW 30.42.120(2)
Asset Maintenance	FCS 1761 & 1762; CCRS 10.16000– 10.16226	C.G.S. Section 36a-428c and promulgation of regulations in progress.	Section 663.07 FS; Rule 3C- 15.006 FAC	No state regulation.	205 ILCS 645/13	BL Section 202-b; GRBB Part 52; SR Part 322	N/A.	RCW 30.42.120
Capital Equivalency Deposits	See previous item.	See previous item.	Section 663.07 FS; Rules 3C- 15.006, 3C- 140.007 FAC	7-1-718(b) OCGA	See previous item.	BL Section 202-b; GRBB Part 51; SR Part 322	N/A.	RCW 30.42.070
Credit Files	FCS 1706; CCRS 10.14725– 10.14730	C.G.S. Section 36a-428h	N/A.	Required to be available and in English.	205 ILCS 645/13	GRBB Part 52 ¹⁴	7 TAC 3.42	WAC 50-32- 070 (Branch); WAC 50-32- 080 (Agency); RCW 30.42.200
Other Items				7-1-719 OCGA Reports; 7-1- 710, 7-1-711	1. Representative Office/ Licensing Procedures: 205 ILCS 650/4. 2. Authorization for Fiduciary Powers: 205 ILCS 645/3.	1. Representative Office/ Licensing Procedures: SP FB 102. 2. Authorization for Fiduciary Powers for branches/ agencies: BL Section 201-b, SP FB 103.	1. Representative Office/ Licensing Procedures: TBA Section 9.006; 7 TAC 3.44	
Footnotes appear	at the end of the	table.						

GA

7-1-718 OCGA 205 ILCS

IL

645/3

NY

BL Sections

 $96^{15}; 103;$

202-f

TX

TBA Section

9.012

CA

FCS 1220-

1239

CT

C.G.S. Section

36a-260, 36a-

261, 36a-265

and 36-266

FL

Sections

663.06;

663.061,

663.64 FS;

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	CA	CT	FL	GA	IL	NY	TX	WA
Other Items Continued					3. Registered Agent: 205 ILCS 645/9.	3. Permission to change name of the banking institution: SB FB 104; BL Section 203. 4. Permission to change branch/ agency's general manager or representative: SP FB 105.		

- 1. Financial Code Section(s).
- 2. Applicable only in a Depository Agency or Branch Office.
- 3. Banking Law.
- 4. The Texas Banking Act.
- 5. Title 7, Texas Administrative Code.
- 6. Policy Memorandum.
- 7. Revised Code of Washington (state law).
- 8. California Code of Regulations Section(s).
- 9. Supervisory Policies.
- 10. Washington Administrative Code (state rulings and regulations).

- 11. General Regulation of the Banking Board.
- 12. Superintendent's Regulations.
- 13. No legal lending limits for foreign banking offices under Illinois law. Section 14 of the Foreign Banking Office Act (205 ILCS 645/14) states, however, that the portion of loans to any one obligor in excess of 10 percent of eligible assets is considered ineligible and not included in the numerator of the asset maintenance ratio.
- 14. Maintenance of the evidence of indebtedness.
- 15. Section 96 is applicable to branches and agencies only, pursuant to banking department policy.

CONNECTICUT

Other Real Estate Owned-No specific statute or regulation.

Debts Previously Contracted—No specific statute or regulation.

Real Estate Appraisals—Section 36a-261 sets forth the real estate appraisal requirements applicable to state chartered banks which also apply to state branches and agencies of foreign banks.

Internal and External Audits—No special statute or regulation.

Bank Secrecy and Anti-Money Laundering—No special statute or regulation concerning bank secrecy. Part XXIII of Chapter 952 of the Connecticut General Statutes makes money laundry an offense under the penal code.

Branch/Agency Licensing Procedures—Section 36a-428a sets forth the requirements for application for a license and the factors that the Banking Commissioner must consider before issuing a license.

Branch/Agency Closing or **Termination** Procedures—Section 36a-428j addresses revocation, suspension or failure to renew a license as well as revocation of a license due to voluntary surrender, or dissolution of the foreign bank or other termination or cancellation of its existence or authority. Section 36a-428k delineates the procedure for voluntary liquidation of the business and property of the state branches and state agencies. Section 36a-145(f) sets forth the notice requirements applicable to branch closings. Part VIII of Chapter 664c concerns failure, receiverships, conservatorships and other emergency actions.

International Banking Facilities-No special statute or regulation.

Deposit Taking—Section 36a-428b provides that the operations of a foreign bank at a state branch or state agency shall be conducted with the same rights and privileges as a state chartered bank at the same location and thus authorizes deposit taking.

Legal Lending Limits-Under Section 36a-428b, the operations of a foreign bank at a state branch or agency are subject to the same restrictions and limitations applicable to a state chartered bank. Therefore, the legal lending limits of Section 36a-262 apply to foreign banks. Under Section 36a-428d, limitations based on the capital stock or surplus of a state chartered bank are deemed to refer to the dollar equivalent of the capital and surplus of the foreign bank.

Permissible Lending Activities-Section 36a-428b gives state branches and state agencies the same lending authority as state chartered banks.

Ineligible Assets—Regulations in progress.

Asset Maintenance—Section 36a-428c requires a foreign bank with a state branch or state agency to hold assets in the state in an amount prescribed by regulation. The promulgation of regulations addressing this is currently in progress.

Capital Equivalency Deposits-Section 36a-428c requires a foreign bank with a state branch or state agency to keep assets on deposit in this state in accordance with regulations. The promulgation of regulations addressing this is currently in progress.

Credit Files-Section 36a-428h requires a foreign bank to maintain or make available at its state branch, state agency or representative office appropriate books, accounts and records relating to or reflecting transactions effected by such branch, agency or office.

FLORIDA

Other Real Estate Owned—Subsection 658.67(9), FS, allows banks to acquire property to protect a loan or investment previously made in good faith. Certain limitations/restrictions apply.

Debts Previously Contracted—See above.

Real Estate Appraisals—Section 655.60, FS, grants the Department the power to require that appraisals be made on loans made by financial institutions under certain conditions. Rule 3C-100.600 contains appraisal standards and policies for state financial institutions.

Internal and External Audits—Subsection 663.09(2), FS, requires that audits be performed of all agencies. Rule 3C-15.012, FAC, contains the Minimum Audit Procedures for agencies.

Bank Secrecy and Anti-Money Laundering—Section 655.50, FS, requires that financial institutions maintain records of large currency transactions and submit currency transaction forms on those transactions. Rule 3C-15-012, FAC, discussed areas that must be checked during an audit to ensure that an agency is complying with anti-money laundering policies and procedures. Rule 3C-1.022, FAC, contains requirements for filing currency transaction reports.

Branch/Agency Licensing Procedures—Section 663.04, FS, discusses the requirements for carrying on a banking business by an international banking corporation. Section 663.05, FS, discusses the procedures for applying for an international office. Section 663.55, FS, discusses capital requirements to establish international offices. Chapter 3C-9, FAC, discusses time frames for processing applications.

Branch/Agency Closing **Termination** orProcedures-Section 663.11, FS, discusses the dissolution of an international banking corporation and the effect such action would have on the state-licensed office. Section 663.06, FS, discusses the surrender or termination of a license to operate an international office in relation to performing permissible activities. Section 658.80, FS, discusses the appointment of a receiver or liquidator. Section 658.81, FS, discusses notice requirements and court confirmation of appointment of the receiver/liquidator. Section 658.82, FS, discusses the powers and duties of a receiver. Section 658.83, FS, discusses the powers and duties of a liquidator. Section 658.84, FS, discusses transfers and other acts in contemplation of insolvency. Section 658.90, FS, discusses receivers and liquidators under supervision of the Department. Section 658.94, FS, discusses what constitutes prima facie evidence of insolvency. Section 658.95, FS, discusses how a bank would start procedures to voluntarily liquidate itself. Section 658.96, FS, discusses the procedures in voluntary liquidation. Rule 3C-15.016, FAC, discusses the surrender of an agency's license.

International Banking Facilities—Section 655.071, FS, defines an IBF and requires noti-

fication to the Department before an IBF can be established. Rule 3C-15.011, FAC, provides administrative rules for IBFs in more detail.

Deposit Taking—Section 663.011, FS, limits the deposits that agencies may receive from customers. Rule 3C-15.003, FAC, discusses permissible activities for agencies, including deposit taking.

Legal Lending Limits—Section 663.083, FS, discusses lending limits of agencies and branches, and states that Sections 658.48 (Loans) and 658.67 (Investments), FS, may be applicable to branches and agencies in certain circumstances. Other possible areas of regulation in the statutes are Sections 658.49 (Loans not exceeding \$50,000), 658.491 (Commercial loans by financial institutions), and 658.51 (Commodity loans), FS. Rule 3C-15.003, FAC, discusses permissible activities of international offices, including loans.

Permissible Lending Activities—Section 663.06, FS, discusses the inability to perform permissible activities when a license is surrendered, revoked, or terminated. Section 663.061, FS, allows international agencies to engage in any loan or investment that could be made by domestic banks. Section 663.64, FS, discusses permissible activities of international branches. Rule 3C-15.003, FAC, discusses permissible activities of international offices, including loans.

Ineligible Assets—Subsections 663.07(5) and (6) discuss ineligible assets.

Asset Maintenance—Section 663.07, FS, discusses asset maintenance. Rule 3C-15.006, FAC, discusses the reporting of asset maintenance data to the Department.

Capital Equivalency Deposits—Section 663.07, FS, discusses capital equivalency requirements. Rule 3C-15.006, FAC, discusses the reporting of capital equivalency data to the Department. Rule 3C-140.007, FAC, provides further clarification of asset maintenance and capital equivalency requirements.

Credit Files—N/A.

ILLINOIS

Other Real Estate Owned—A foreign banking office may own other real estate in the collection

of its debts but may not hold title for more than five years unless a request for extension is submitted in writing and approved by the Commissioner. The maximum time period is ten years. 205 ILCS 5/5(9), Rule (Title 38/Chapter II/Part 354).

Debts Previously Contracted—A foreign banking office may maintain assets it acquires in collection of debt. A rule has been adopted for the administration of these assets. Rule (Title 38/Chapter II/Part 354).

Real Estate Appraisals-No statutes or rules govern real estate appraisals.

Internal and External Audits—Although no statutes or rules are in place governing internal and external audits, examiners will recommend that an internal program be maintained by the bank. This could include personnel located at the branch or at a regional office. A particular situation could be present that warrants recommendation for an outside audit.

Bank Secrecy and Anti-Money Laundering—No statutes or rules govern bank secrecy and antimoney laundering.

Branch Licensing Procedures-Foreign banks are required to receive a Certificate of Authority to operate a foreign banking office (branch) in the State of Illinois. A foreign bank may establish and maintain banking offices in the State. The application requires information that is specifically stated in the statutes. (205 ILCS 645/3 through 205 ILCS 645/19) Additionally, the bank must indicate whether Illinois will be the "home state" pursuant to the IBA 78; if not, an agreement must be signed with the Federal Reserve restricting the types of deposits to be received at the Illinois office. Applications may be obtained by contacting the State of Illinois, Office of Banks and Real Estate.

Branch Closing or Termination Procedures—A branch closing or termination is identified in the statutes. (205 ILCS 645/19) A voluntary surrender of the Certificate of Authority should be accompanied by an affidavit stating there are no liabilities of any kind remaining at the Illinois office.

International Banking Facilities—Illinois recognizes the International Banking Facilities (IBF) and had amended its tax law in 1981 to provide for state tax exemption of income generated from IBF accounts. (35 ILCS 5/30(2)).

Deposit Taking—The Certificate of Authority issued to a foreign bank pursuant to Illinois statute provides full banking powers (205 ILCS 645/3). The deposit powers are not utilized by the bank if an agreement between the bank and the Federal Reserve is signed pursuant to the IBA 78, which limits the deposit taking to that defined in section 25(a) of the FRA.

Legal Lending Limits—There are no legal lending limits for foreign banking offices under Illinois law. However, Section 14 of the Foreign Banking Office Act (205 ILCS 645/101) states that the portion of loans to any one obligor in excess of 10 percent of eligible assets is considered ineligible and should not be included in the numerator of the asset maintenance ratio.

Permissible Lending Activities—205 ILCS 645/3 state that a foreign banking office may conduct a general banking business with the same, but no greater rights and privileges, as a state bank.

Ineligible Assets—Ineligible assets are those assets not included in the numerator of the asset maintenance ratio. This ratio, as described in Section 13 of the Foreign Banking Office Act (205 ILCS 645/31), is required to be maintained at all times. The following is a list of ineligible assets, although it is not all inclusive: (Refer to Monthly Report of Statutory Requirements instruction book for details.)

- · Amounts due from head office, branches, agencies, and wholly-owned subsidiaries.
- · Fixed assets.
- That portion of loans to one borrower in excess of 10 percent of eligible assets.
- Loans classified Loss and the designated loss portion of Doubtful accrual accounts.
- · Loans not supported by proper credit documentation.
- · Difference between book value and the lower of par or market value of securities (amount could be added or subtracted from assets depending on book value relationship to lower of par or market).

Asset Maintenance—Section 13 of the Foreign Banking Office Act (205 ILCS 645/13) describes a relationship of certain assets to certain liabilities that may be maintained by a foreign banking office. This figure is the asset maintenance ratio: ineligible assets divided by liabilities requiring cover; it is to be set by the Commissioner. Currently, the ratios are imposed when Supervisory concerns exist at local, national or global levels. The ratio, when required, needs to be maintained at all times and is monitored via the Monthly Report of Statutory Requirements and the on-site examinations.

Capital Equivalency Deposits—Pledged asset requirements may be imposed when Supervisory concerns exist.

Credit Files—Credit files are to be maintained at the branch for all loans booked. Loans not supported by proper documentation may be deemed ineligible by the examiner in determining the asset maintenance ratio. Refer to (205 ILCS 645/13), which states, in part, the Commissioner shall have the right to determine the value of assets ...for purposes of computing the ratio.

WASHINGTON

Other Real Estate Owned—An alien bank may hold and convey real estate acquired at sale under judgements, decrees, liens, or mortgage foreclosures against securities held by it. There is a five-year holding limit as a bank asset unless an extension of time is granted by the Supervisor.

Debts Previously Contracted—In order to prevent loss on debts previously contracted, a branch may acquire shares in a corporation provided that such shares are disposed of within two years from acquisition date.

Real Estate Appraisals—A branch has the power to make loans the same as a state-chartered commercial bank; therefore, a branch must comply with applicable state and federal regulations. An agency can be involved in making loans only for the financing of the international movement of goods and services, for operational needs, and for the purchase of fixed assets. If secured by real estate, the implication is that they must comply with state and federal regulations.

Internal and External Audits—Not required by statute or regulation.

Bank Secrecy and Anti-Money Laundering—Federal regulations apply for branch/agency.

Branch/Agency Licensing Procedures— Application must be approved by the Supervisor of Banking after investigating the proposal for compliance with conditions delineated in statute and applicant has met all conditions precedent to establishing an office in the state.

Branch/Agency Closing orTermination Procedures—The Supervisor may suspend or revoke the Certificate of Authority of an alien bank for issues relating to violations of laws and regulations, conducting business in an unauthorized manner, and unresponsiveness to the Supervisor's orders or directives as well as if the bank is in an unsafe or unsound condition, the bank cannot with safety continue business, or the alien bank's country is unjustifiably refusing state banks to operate in the alien bank's country. The Supervisor may take possession of an alien office as provided by statute.

International Banking Facilities—Permitted under federal regulations (FRB); applicant must notify the local Federal Reserve Bank. State revenue laws allow IBFs.

Deposit Taking Branch Only—Any branch of an alien bank that filed its application before July 27, 1978, and has designated Washington as its home state pursuant to the International Banking Act (IBA) of 1978 shall have the power to solicit and accept deposits the same as a state-chartered commercial bank, except that acceptance of initial deposits of less than \$100,000 shall be limited to deposits delineated by statute. (The same as provided by the IBA.) Deposits must be either insured by the FDIC or arrangements made for capital maintenance in accordance with provisions of RCW 30.42.120.

Legal Lending Limits—The base for computing the applicable loan limitation is the entire capital and surplus of the alien bank. The loan limit is the same as a state-chartered commercial bank, or 20 percent of the capital surplus of the bank, with certain exceptions.

Permissible Lending Activities—An approved branch of an alien bank shall have the same power to make loans and guarantee obligations as a state-chartered commercial bank. An approved agency may engage in the business of

making loans and guaranteeing obligations for the financing of the international movement of goods and services and for all operational needs, including working capital and short-term operating needs for the acquisition of fixed assets.

Ineligible Assets—Assets ineligible for asset maintenance calculations include amounts due from head office and any other branch, agency, or other office or wholly-owned subsidiary of the bank, except those amounts due from such offices or subsidiaries located within the United States and payable in U.S. dollars.

Asset Maintenance Branch Only—100 percent of aggregate liabilities of such alien bank must be held and payable at or through its office in this state. The funds so held are to be currency, bonds, notes, debentures, bills of exchange, or other evidences of indebtedness or other obligations payable in the United States or in U.S. funds, or, with the approval of the Supervisor, in funds freely convertible in U.S. funds or such other assets as are approved by the Supervisor. Interoffice due from accounts are excluded from the calculation, except amounts due from offices or subsidiaries located within the United States and payable in U.S. dollars.

Capital Equivalency Deposits-Capital allocated shall be maintained within the state at all times in cash or in Supervisor-approved (1)interest bearing bonds, notes, debentures, or other obligations of the United States, agency, or instrumentality thereof, or guaranteed by the United States or the state of Washington, or (2) other such assets as the Supervisor may approve. Such capital must be deposited with a bank whose principal place of business is located in this state. The capital equivalency deposits are held under tripartite agreement and are held for the sole benefit of U.S.-domiciled creditors of such alien bank's Washington state office and is subject to the Supervisor's order without offset for the payment of such creditors.

Credit Files—A branch must maintain loan records and controls that include the organizing and maintenance of credit files incorporating loan comments, credit analysis, financials, etc. The same is applicable to an agency. RCW 30.42.200 requires the books and accounts of an office to be in the English language.

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