

USING THIS MANUAL

This manual seeks to provide the examiner with guidance for reviewing capital-markets and trading activities at all types and sizes of financial institutions. The manual will be updated periodically as products and activities evolve.

The manual codifies current procedures used in the review of capital-markets and trading activities. It discusses the risks involved in various activities, risk-management and -measurement techniques, appropriate internal controls, and the examination process from the following perspectives:

- *Global applicability.* The manual is not directed at trading at any one type of institution (commercial bank, branch/agency, other) but is meant to apply to capital-markets and trading activities at all financial institutions to be examined.
- *Portfolio.* The manual attempts to broaden our review of trading operations from a product-by-product approach to a portfolio and functional-activity approach. This method better reflects the multiple uses of financial instruments by institutions, their relationship to other instruments and activities on or off the balance sheet, and attendant correlations.
- *Types of risk.* The manual identifies the range of risks—market, credit, liquidity, operational, legal, and other risks—relevant to the review of capital-markets and trading activities, and discusses their management on a functional and legal-entity basis.

The manual is divided into four basic sections. The first section consists of broad introductory remarks regarding the examination of most capital-markets and trading activities, including important considerations in preparing for the examination and review of capital-markets activities. It also discusses the importance of examiner review of the management organization of the activity to be examined.

The second section presents supervisory guidance regarding trading and dealer operations at banking organizations and specifically details certain aspects of the examination process for these operations. In general, the discussion of each topic has the following four subsections:

- discussion of the general topic

- examination objectives
- examination procedures
- internal control questionnaire

The focus of the examination objectives, examination procedures, and internal control questionnaires is to provide examiners with a practical guide to examining the core areas of any trading operation. Examination objectives describe the goals that should be of primary interest to the examiner and determine the scope of the examination for the specific area of interest. The examination procedures include procedures to be performed during a comprehensive examination. In some instances, not all the procedures may apply to all financial institutions. Thus, examiners have the flexibility, depending on the characteristics of the particular institution under examination, to determine the examination scope and procedures. The materiality and significance of a given area of operations are an examiner's primary considerations when deciding the scope of the examination and the procedures to be performed. Examiner flexibility results in examinations tailored to the operations of the banking institution. After determining the proper objectives and procedures, the examiner will have an organized approach to examining the institution's trading processes. Core topics include the following:

- market risk
- credit risk
- settlement risk
- liquidity risk
- operations and systems risk
- legal risk
- financial performance
- capital adequacy of trading activities
- accounting
- regulatory reporting
- regulatory compliance
- ethics

The third section of this manual offers supervisory guidance regarding various banking activities and functions that are not trading-related but are directly linked with capital-markets and Treasury operations. While targeted primarily at larger institutions, the general principles identified in this section are applicable to activities at institutions of all sizes. This section presents the latest Federal Reserve

supervisory guidance on issues such as interest-rate risk management within the banking book, securitization and secondary-market credit activities, securities and end-user derivative activities, and other topics. In some cases, the guidance consists of Federal Reserve supervision and regulation (SR) letters on specific topics. In others, formal examination-manual treatments are presented that include exam procedures and internal control questionnaires.

The fourth section of this manual presents profiles of specific financial instruments commonly encountered in capital-markets and trading activities. An examiner's understanding of these instruments is crucial to successful implementation of a capital-markets examination. While the write-ups are not intended to provide in-depth and fully comprehensive coverage of each instrument, they do present basic instrument characteristics and examination considerations. In general, each instrument profile contains discussions in the following areas:

- general description
- characteristics and features
- uses
- description of the instrument's market
- pricing conventions
- hedging issues
- discussion of the risks involved
- accounting treatment
- risk-based capital considerations
- bank-eligibility requirements
- references for further information

When assigned to review a particular product, the examiner should first review the appropriate instrument profile to become familiar with the characteristics of and the marketplace for the product. The examination objectives, examination procedures, and internal control questionnaires will often be applicable across any number of instruments and products. Therefore, coordination with examiners who are reviewing other products is essential.

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