

# Commercial Bank Examination Manual

## Supplement 37—April 2012

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### Summary of Changes

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

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2000.1, 2000.3, and 2000.4 on “Cash Accounts” and section 4128.1, “Private Banking Activities,” were revised to remove outdated references to suspicious activity report filings.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

#### *Section 2040.1*

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

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

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

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

#### *Section 2142.1*

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

guidance supplements section 2140.1, “Agricultural Loans.”

### *Section 3000.3*

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

### *Section A.2040.3*

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

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### Summary of Changes

#### *Section 2020.1*

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

#### *Section 2025.1*

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

#### *Section 2047.1*

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

#### *Section 3020.1*

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

#### *Sections 4063.1 and 4063.3*

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

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

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

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### Summary of Changes

#### *Section 1000.1*

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

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

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

#### *Section 2040.1*

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

#### *Section 2040.3*

The section on the “Loan Portfolio

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

#### *Section 3000.1*

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

#### *Section 3020.1*

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

#### *Section 4027.1*

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

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

### *Sections 4030.1 and 4030.3*

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

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

The sections on "Real Estate Appraisals and

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

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# Commercial Bank Examination Manual

## Supplement 34—October 2010

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### Summary of Changes

#### *Section 2016.1*

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

#### *Section 4008.1*

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

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

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

#### *Section 4020.1*

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

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

#### *Section 4050.1*

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

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# Commercial Bank Examination Manual

## Supplement 33—April 2010

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### Summary of Changes

#### *Foreword*

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

#### *Preface*

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

#### *Section 1000.1*

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

#### *Section 2200.1*

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

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

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

#### *Section 4052.1*

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

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# Commercial Bank Examination Manual

## Supplement 32—October 2009

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### Summary of Changes

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

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

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

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

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

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

#### *Sections 2190.1 and 2190.3*

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

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

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

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

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

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### Summary of Changes

#### *Section 3020.1*

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

#### *Section 4125.1*

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

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

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

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

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

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

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

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

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

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### Summary of Changes

#### *Section 3020.1*

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

#### *Section 4030.1*

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

#### *Sections 4060.1–4060.4*

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

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

#### *Section 4150.1*

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

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# Commercial Bank Examination Manual

## Supplement 29—April 2008

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### Summary of Changes

#### *Section 1000.1*

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

#### *Sections 1010.1*

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

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

#### *Section 5020.1*

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

#### *Section 6000.1*

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

### FILING INSTRUCTIONS

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# Commercial Bank Examination Manual

## Supplement 28—October 2007

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### Summary of Changes

#### *Section 1000.1*

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

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

#### *Sections 2103.2–2103.4*

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

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

#### *Section 2135.1*

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

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

#### *Sections 3030.1–3030.4*

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

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

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

### *Section 4033.1*

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

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

### *Section 6010.1*

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

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# Commercial Bank Examination Manual

## Supplement 27—May 2007

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### Summary of Changes

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

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

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

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

#### *Section 2070.1*

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

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

#### *Section 2103.1*

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

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

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

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

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

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

### *Section 3020.1*

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

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

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

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

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# Commercial Bank Examination Manual

## Supplement 26—November 2006

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### Summary of Changes

#### *Sections 2040.1 and 2040.3*

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

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

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

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

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

#### *Section 3020.1*

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

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

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

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

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

### *Section 4030.1*

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

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

### *Section 4063.1*

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

### *Sections 4133.1 and 4133.3*

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

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

*Sections 4140.1, 4140.2, 4140.3, and 4140.4*

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

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

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# Commercial Bank Examination Manual

## Supplement 25—May 2006

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### Summary Of Changes

#### *Section 1000.1*

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

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

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

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

#### *Section 1015.1*

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

#### *Section 1020.1*

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

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

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

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

### *Section 4042.3*

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

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

### *Sections 4050.1 and 4128.1*

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

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

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

### *Section 5020.1*

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

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

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

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# Commercial Bank Examination Manual

## Supplement 24—November 2005

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### LIST OF CHANGES

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

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

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

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# Commercial Bank Examination Manual

## Supplement 23—May 2005

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### LIST OF CHANGES

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

Section number	Description of the change
3015.1	A new section, “Deferred Compensation Agreements,” has been added to the “Liabilities and Capital” chapter. The section provides guidance from the February 11, 2004, Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance. The advisory was issued because the agencies, through the examination process, identified many institutions that had incorrectly accounted for obligations under a type of deferred compensation agreement commonly referred to as a <i>revenue-neutral plan</i> or an <i>indexed retirement plan</i> . The advisory informs institutions that they need to review their accounting for deferred compensation agreements to ensure that the agreements have been appropriately measured and reported. (See SR-04-4 and SR-04-19.)
4042.1	A new section, “Purchase and Risk Management of Bank-Owned Life Insurance,” provides the text of the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance. The statement discusses the safety-and-soundness and risk-management implications of purchases and holdings of life insurance by banks. The agencies issued the guidance because they were concerned that some institutions may not have an adequate understanding of the risks associated with BOLI, including its liquidity, operational, reputational, and compliance/legal risks. Further, institutions may have committed a significant amount of capital to BOLI holdings without properly assessing the associated risks. When an institution is planning to acquire BOLI that will result in an aggregate cash surrender value in excess of 25 percent of its tier 1 capital plus the allowance for loan and lease losses, the agencies expect the institution to obtain the prior approval of its board of directors or its designated board committee. The guidance addresses the need for institutions to conduct comprehensive pre- and post-purchase analyses of BOLI, including its unique characteristics, risks, and rewards. Institutions are expected to have comprehensive risk-management processes for their BOLI purchases and holdings; these processes should be consistent with safe and sound banking practices. (See SR-04-4 and SR-04-19.)
4043.1	The “Insurance Sales Activities and Consumer Protection in Sales of Insurance” section has been revised to include the following references: <ul data-bbox="253 1150 994 1203" style="list-style-type: none"><li>• the recently updated discussion on tying arrangements (section 2040.1)</li><li>• the new BOLI supervisory guidance (section 4042.1)</li></ul>
4050.1	The “Bank-Related Organizations” section has been revised to incorporate the U.S. Department of the Treasury’s regulation regarding foreign correspondent accounts. The regulation became effective October 28, 2002. (See 31 CFR 103.177 (amended as of December 24, 2002) and 103.185.) The regulation implemented sections 313 and 319(b) of the USA Patriot Act. A covered financial institution (CFI) is prohibited from establishing, maintaining, administering, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank (a foreign bank that has no physical presence in the United States or other jurisdictions) that is <i>not</i> affiliated (1) with a U.S.-domiciled financial institution or (2) with a foreign bank that maintains a physical presence in the United States or a foreign country and is supervised by its home-country banking authority. A CFI that maintains

*Section number**Description of the change*

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

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

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

4063.4

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

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

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

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

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# Commercial Bank Examination Manual

## Supplement 22—November 2004

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### LIST OF CHANGES

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

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

*Section number**Description of the change*

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

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

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

3000.1,  
3000.2,  
3000.3,  
3000.4

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

3020.1,  
3020.3

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

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

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

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

4030.1,  
4030.2,  
4030.3,  
4030.4

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

4125.1,  
4125.3

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

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

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# Commercial Bank Examination Manual

## Supplement 21—May 2004

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

*Section number**Description of the change*

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

4140.1,  
4140.3,  
4140.4

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

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

4180.1,  
4180.2,  
4180.3,  
4180.4

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

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

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

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

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

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