The subsections following this introduction address the Board's supervisory authority over, and reporting requirements for foreign banking organizations. Supervisory policy statements issued by the Board or the Federal Financial Institutions Examination Council in conjunction with other federal financial institution regulatory agencies are also discussed. Foreign banks continue to expand their operations in the United States and are significant participants in the U.S. banking system. As of December 31, 1991, 313 foreign banks operated 529 state-licensed branches and agencies (of which 53 had FDIC insurance) and 84 branches and agencies licensed by the Office of the Comptroller of the Currency (of which 9 had FDIC insurance). Foreign banks also directly owned 11 Edge corporations and 13 commercial lending companies. In addition, foreign banks held an interest of at least 25 percent in 90 U.S. commercial banks. Together, these foreign banks controlled approximately 24 percent of U.S. banking assets.

The Federal Reserve has broad authority for the supervision and regulation of foreign banks that engage in banking in the United States through branches, agencies, and commercial lending companies. Foreign banks owning Edge corporations or U.S. banks are more directly subject to Federal Reserve supervision—in the former case as the Edge's chartering authority and in the latter as primary supervisor of bank holding companies. In all cases, the Board is primarily responsible for supervising the U.S. nonbanking operations of foreign banks with a U.S. banking presence.

Before the December 19, 1991 passage of the Federal Deposit Insurance Corporation Improvement Act, the Federal Reserve had residual authority to examine all branches, agencies, and commercial lending subsidiaries of foreign banks in the United States. The International Banking Act of 1978 instructed the Federal Reserve to use, to the extent possible, the examinations reports of other state and federal regulators. The FDICIA amended the International Banking Act and increased the Federal Reserve's authority with respect to these foreign bank operations, including representative offices, in the United States. The Federal Reserve may coordinate the examinations of foreign bank operations with other state and federal regulators. Branches and agencies are now required to be examined at least once during each twelve-month period in an on-site examination.

The FDICIA also authorized the Federal Reserve to terminate the operations of foreign banks in the United States under certain conditions. The legislation requires Federal Reserve approval to establish foreign bank branches, agencies, commercial lending subsidiaries, and representative offices in the United States.

2100.1.1 POLICY STATEMENT ON THE SUPERVISION AND REGULATION OF FOREIGN BANKING ORGANIZATIONS

On February 23, 1979, the Board issued a statement of policy on supervision and regulation of foreign banking organizations that control a U.S. subsidiary bank. The policies set forth in this statement continue to provide the framework within which the Board analyzes foreign bank acquisitions of U.S. banks. The Board has stated in a number of cases it has acted upon since 1984, that it views as ''a negative factor'' the failure of a foreign bank's stated capital ratio to meet the Board's capital adequacy guidelines. In addition to certain mitigating factors such as the existence of ''hidden reserves'' or a highly liquid funding position, the Board has relied upon assurances and commitments that the capital adequacy of the U.S. bank subsidiary will be maintained at a high level to offset this ''negative factor.'' Following are major excerpts from the policy statement.

The Board of Governors has a number of supervisory responsibilities over the operations of foreign banking organizations in the United States under the Bank Holding Company Act and under the International Banking Act of 1978. In order to inform the public and the banking industry, the Board issued this statement setting forth its policy toward regulating foreign bank holding companies in the United States.

Bank supervision in the United States has as a principal objective, the promotion of the safety and soundness of banking institutions as going concerns serving depository and credit needs of their communities and the economy as a whole. To this end, a number of standards have been established governing domestic entry into the banking business and ongoing supervision of banking operations of domestic banks and bank holding companies.

In urging legislation to provide for federal regulation of foreign banks in the United States, the Board endorsed the principle of national treatment, or nondiscrimination, as a basis for the rules governing the entry and subsequent operations of foreign banks in this country. The International Banking Act of 1978 generally incorporates that principle in its provisions.

The Board continues to believe that the principle of national treatment should be the guiding rule in administering the Bank Holding Company Act and the International Banking Act of 1978 as they affect foreign banks. Following this rule, the Board believes that in general, foreign banks seeking to establish banks or other banking operations in the United States should meet the same general standards of strength, experience and reputation as required for domestic organizers of banks and bank holding companies. The Board also believes that foreign banks should meet on a continuing basis these standards of safety and soundness if they are to be a source of strength to their U.S. banking operations.

At the same time, the Board is cognizant that foreign banks operate outside the United States in accordance with different banking practices and traditions and in different legal and social environments. The Board also recognizes that its supervisory responsibilities are for the safety and soundness of U.S. banking operations. Its supervisory concerns for the operations and activities of foreign banks outside the United States are, therefore, limited to their possible effects on the ability of those banks to support their operations inside the United States. As embodied in both the Bank Holding Company Act and the International Banking Act of 1978, it is the general policy of the Board not to extend U.S. bank supervisory standards extraterritorially to foreign bank holding companies. The Board will give due regard to these factors in applying the principle of national treatment.

The Board has jurisdiction over foreign entry in the case of foreign organizations seeking to acquire U.S. banks. Whenever a foreign bank applies to become a bank holding company, the Board will seek to assure itself of the foreign bank's ability to be a source of financial and managerial strength and support to the U.S. subsidiary bank. In reaching this judgment, the Board will analyze the financial condition of the foreign organization, evaluate the record and integrity of management, assess the role and standing of the bank in its home country, and request the views of the bank regulatory authorities in the home country. In connection with its financial analysis, the Board will require sufficient information to permit an assessment of the financial strength and operating performance of the foreign organization. Information will consist of reports prepared in accordance with local practices together with an explanation and reconciliation of major differences between local accounting standards and U.S. generally ac-

cepted accounting procedures including full information on earnings, capital, charge-offs, and reserves. The Board will also continue to work with bank supervisory authorities of other major countries to improve overall cooperation in international bank regulation.

Once a foreign bank holding company has been established, Board supervisory procedures will be primarily directed at promoting the safety and soundness of the subsidiary U.S. banks. Examinations carried out by the relevant federal and/or State supervisory authority will continue to be the primary instrument for this purpose. Special attention will be given to transactions and correspondence between the U.S. subsidiary bank and its foreign parent and to monitoring credits by the U.S. bank to parties that are also customers of the parent. In particular, federal bank supervisors will expect the U.S. bank to maintain sufficient information on all borrowers to permit both the U.S. bank and bank examiners to make an independent appraisal of the bank's credits. In addition to the examination process, the Board will require foreign bank holding companies to report semiannually on transactions between the U.S. subsidiary bank and its foreign parent.

The Board requires submission of sufficient financial information to enable it to assess the operations and general condition of the parent institution. In particular, full information on earnings, reserves and capital will be required along with an explanation of major material differences between U.S. and foreign accounting practices. In its use and handling of the information, the Board will take into account the fact that much of the information required may be confidential commercial information that is not generally disclosed and the parent's majority owned subsidiaries.

2100.1.2 INTERAGENCY POLICY STATEMENT ON THE SUPERVISION OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS

A second policy statement was issued on July 20, 1979, through the Federal Financial Institutions Examination Council on the supervision of U.S. branches and agencies of foreign banks. Principal excerpts from this statement are as follows:

The International Banking Act of 1978 gives the three Federal bank regulatory agencies expanded supervisory authority and responsibility with respect to the operations of foreign banks' U.S. branches, agencies, and commercial lending companies.[1] It provides for the establishment of Federal branches and agencies by the Office of the Comptroller of the Currency and permits U.S. branches to apply for insurance coverage by the Federal Deposit Insurance Corporation. It also subjects these U.S. offices to many provisions of the Federal Reserve and Bank Holding Company Acts.

In order to insure adequate supervision of these offices within the present Federal-State regulatory framework, the IBA provides that the Comptroller, the FDIC, and the various State authorities will have primary examining authority over the offices within their jurisdictions. Additionally, the Act gives the Federal Reserve Board residual examining authority over all U.S. banking operations of foreign banks, similar to its existing authority over U.S. subsidiary banks of bank holding companies. This distribution of responsibilities calls for close coordination of the efforts of the relevant authorities. Accordingly, the Comptroller, the FDIC, and the Board, in coordination with the Federal Financial Institutions Examination Council (FFIEC), issued this joint statement to inform the public and the banking industry of their supervisory policy toward these U.S. offices.

The agencies' supervisory interests in the operations of U.S. branches and agencies of foreign banks are directed to the safety and soundness of those operations in serving the needs of borrowers and depositors and other creditors in the United States. For this reason, the regulatory agencies place primary emphasis on assessing the financial well-being of the U.S. offices. They are also concerned with adherence to U.S. law and regulation by these offices.

At the same time, the agencies recognize that, even more than in the case of U.S. bank subsidiaries of foreign banks, the strength of these branches and agencies devolves from their head offices and organizations outside the United States and that ultimate responsibility for branch and agency activities resides in head offices overseas. Consequently, the agencies will seek to assure themselves that the parent institutions are financially sound. To this end, they will collect information on the consolidated operations of the foreign banks and expand their contacts with senior managements of the banks.

1. The term "commercial lending companies" is intended to refer to investment companies organized under Article XII of the New York State Banking Law, and any similar corporations that may be organized under the laws of other States.

Additionally, United States authorities are working and will continue to work with bank supervisory authorities of other nations to improve both the coordinated exchange of banking information and the compatibility of international banking regulation.

The International Banking Act of 1978 mandates that the Federal regulatory agencies cooperate closely with State banking authorities in examining U.S. offices of foreign banks. In furtherance of this mandate, a uniform approach to examining these offices has been developed through the FFIEC in order to minimize dual examinations and to facilitate joint Federal-State examinations, when desirable. In exercising their responsibilities, the agencies will ensure that each U.S. office of a foreign bank is examined regularly by either State or Federal authorities.

2100.1.3 BOARD REPORTING REQUIREMENTS FOR FOREIGN PARENT INSTITUTIONS

To gain information on the consolidated bank, the Board has developed reporting requirements for the foreign parent institutions. These information requirements are the same as those for foreign bank holding companies, including disclosure of specific information on earnings, reserves, and capital, and an explanation for material differences between U.S. and foreign accounting practices. In use and handling of this information, the (Board) will take into account the fact that some of the information required may be confidential commercial information that is not generally disclosed.

2110.0.1 INTRODUCTION

2110.0.1.1 Changes Resulting from the Enforcement Provisions and Other Related Sections of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (''FIRREA'') and the Comprehensive Thrift and Bank Fraud Act of 1990 (the ''Bank Fraud Act'')

The provisions of Title IX of FIRREA and several provisions of the Bank Fraud Act granted the Board of Governors, as well as the other federal financial institutions supervisory agencies, numerous new or enhanced enforcement powers over financial institutions and individuals associated with them. The new or enhanced enforcement powers granted, under FIRREA and the Bank Fraud Act, to the Board of Governors and the new responsibilities of banking organizations (and individuals associated with them) that are supervised by the Federal Reserve are as follows:[1]

1. In order to simplify the numerous and lengthy references to ''directors, officers, employees, agents and persons participating in the conduct of the affairs of a financial institution'' contained in the enforcement statutes and to expand the banking agencies' jurisdiction over individuals associated with financial institutions, the term ''institution-affiliated party'' is substituted in the law each time there is a reference to one of the aforementioned individuals. Thus, the Board has enforcement powers, such as cease and desist, removal, prohibition and civil money penalty assessment authority, now over certain financial institutions and institution-affiliated parties including controlling shareholders.

In addition, the term ''institution-affiliated party'' has been expanded to include independent attorneys, appraisers, and accountants, as well as other independent contractors, who knowingly or recklessly participate in any law or regulation violation, any breach of fiduciary duty or any unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution.[2] In this manner, the Board has added responsibilities for monitoring and addressing through enforcement actions, where necessary, the activities of whole new categories of persons who work with or for financial institutions subject to our regulatory jurisdiction.

2. The Bank Fraud Act provides that all of the enforcement powers that the Federal Reserve has against domestic financial institutions and their institution-affiliated parties, such as the authority to initiate cease and desist, civil money penalty assessment and removal and prohibition actions, are applicable to foreign financial institutions and their branches and agencies doing business in the United States and their institution-affiliated parties.

3. The Bank Fraud Act provides for criminal penalties against anyone who corruptly obstructs or attempts to obstruct the examination of a financial institution by the financial institution's supervisory agency.

4. The power to suspend and remove an institution-affiliated party who has been indicted (section 8(g) of the Federal Deposit Insurance Act (the ''FDI Act'')) from a state member bank has been expanded so that it now covers institution-affiliated parties associated with bank holding companies, nonbank subsidiaries of bank holding companies and foreign entities subject to the Board's jurisdiction, such as Edge or agreement Act corporations, and certain branches and agencies.

The Board's general power to suspend, remove and permanently prohibit an institution-affiliated party from a state member bank or bank holding company (section 8(e) of the FDI Act) was expanded to cover individuals associated with the foreign entities described above, provided that the activities that give rise to the bases for the suspension, removal, or permanent prohibition action took place in the United States.

5. The requirement that the Board initiate a cease and desist action against a state member bank when recurrent violations of the Bank Secrecy Act and internal control deficiencies relating to compliance with that act are uncovered (section 8(s) of the FDI Act) has been

1. To the extent possible, the description of the provisions of Title IX of FIRREA follow the sequence of the sections in Title IX. They are not being listed in any order of importance.

2. The Board is also authorized to issue regulations further defining which individuals should be considered as institution-affiliated parties due to their participation in the conduct of the affairs of an institution. Similarly, the Board can make a determination whether a person is an institution-affiliated party due to his or her participation in the conduct of the affairs of an institution on a case-by-case basis.

expanded to cover the same institutions described in item 4 above.

6. When the Board issues a cease and desist order or a Federal Reserve Bank executes a written agreement, they may not only order the institution to ''cease and desist'' from its illegal activities or unsafe or unsound practices, but they can, under the law (sections 8(b) and (c) of the FDI Act), also order the entity or individual to take ''affirmative action'' to correct the conditions resulting from its violations or practices. Under FIRREA, the term ''affirmative action'' has been clarified to include certain enumerated powers. These now include the power to order (a) restitution or reimbursement in those instances where there was unjust enrichment or a reckless disregard for the law, (b) restrictions on growth, (c) the disposal of a loan or other asset, (d) the rescission of an agreement or a contract, and (e) the employment of a qualified officer or employee at a financial institution, who may be, at the option of the Board, subject to approval by the Federal Reserve.

Under the Board's cease and desist and temporary cease and desist powers (sections 8(b) and (c) of the FDI Act), the Board can also now issue an order (or execute a written agreement) that places ''limitations on the activities or functions'' of a financial institution or an institution-affiliated party.

7. The grounds for the issuance of a temporary order to cease and desist (section 8(c) of the FDI Act) were modified to reduce somewhat the burden on the Board. This was done by replacing the term ''substantial financial loss'' with the term ''significant financial loss'' and eliminating the modifying word ''seriously'' from the term ''seriously prejudice the interests of the'' bank's depositors. The Board now needs to determine, among other statutory factors needed in order to initiate a temporary cease and desist action, that the institution's or individual's unsafe or unsound practice or law or regulation violation is likely to cause ''significant financial loss'' to the institution or ''prejudice'' the interests of the bank's depositors.

The statutory bases for the issuance of a temporary cease and desist order were also expanded to authorize the issuance of such an order if the Board determines that a financial institution's books and records are so incomplete that the financial condition of the institution or the purpose for a transaction cannot be determined.

8. The Bank Fraud Act authorizes the FDIC to prohibit or limit, by order or regulation, any golden parachute payment or indemnification payment made by an insured depository institution or bank holding company to any institution-affiliated party of an insured depository institution.

The term ''golden parachute'' is generally defined as any payment or any agreement to make a payment to an institution-affiliated party that is contingent on the termination of the party's affiliation with the institution or holding company and is received on or after the date which the institution (a) is declared insolvent; (b) is notified by the appropriate federal banking agency that the institution is in a troubled condition; (c) has been assigned a CAMELS composite rating of 4 or 5; or (d) is subject to a termination of insurance proceeding by the FDIC. Several other factors are considered in determining if a payment is a ''golden parachute.''

The term ''indemnification payment'' is defined to include any payment or any agreement to make a payment by any insured depository institution or bank holding company for the benefit of any person, who is an institution-affiliated party, to pay or reimburse such person for any liability or legal expense with regard to any administrative proceeding or civil action initiated by a federal banking agency that results in the issuance of a final cease and desist, civil money penalty assessment, or removal or prohibition order.

While the Bank Fraud Act does not specifically authorize the Board to prohibit these payments, the Board refers these matters to the FDIC for action whenever the Board becomes aware of such payments by a bank holding company or a state member bank. Also, the Board may use its general cease and desist authority to prohibit such payments if they are deemed to be an unsafe or unsound practice.

9. The statutory language relating to the removal and suspension of an institution-affiliated party (old sections 8(e)(1) and (2) of the FDI-Act) were merged and simplified. Now, the statutory bases are the same whether the Board removes or suspends an individual from an institution based on conduct at his or her present employer or based on conduct at the individual's prior place of employment. In addition, the necessity for determining that an individual's conduct caused ''substantial'' financial loss or ''seriously'' prejudiced the bank's depositors

has been eliminated by the deletion of the terms "substantial" and "seriously".

10. 12 U.S.C. 1818(e)(7) now has a provision that makes one banking agency's suspension, removal or prohibition order universally effective against the individual subject to the order. That is, in the event that the Board removes an individual from a state member bank, that individual cannot work for any other financial institution that is subject to the regulatory jurisdiction of the federal financial institutions supervisory agencies without prior approval of the agency that issued the order in the first place and the regulator of the new employer institution. Violations by any individual of his or her suspension, removal or prohibition order (e.g., the removed individual goes to work for another financial institution without the requisite agency approvals) are now punishable as a felony, with a potential fine of up to $1 million and a prison term of up to five years (section 8(j) of the FDI Act).

A provision of Title IX of FIRREA modified the Board's suspension, removal and prohibition powers. It contemplates the issuance of a suspension, removal or prohibition order against a "corporation, firm, or other business enterprise" in addition to the issuance of such an order against an institution-affiliated party.

11. 12 U.S.C. 1818 (i)(3) corrected the problem relating to jurisdiction for removal and prohibition actions in the event that an individual leaves a financial institution prior to the initiation of the action. With respect to all formal enforcement actions that the Board can take—including cease and desist, removal, prohibition and civil money penalty assessment—the law now provides that the resignation, termination of employment or separation caused by the closing of an institution will not affect the Board's enforcement powers over an individual, provided that any notice (such as a notice of intent to remove from office and of prohibition) is served on an individual before the end of a six-year period starting when he or she left the financial institution, regardless of whether or not such date occurs before, on or after August 9, 1989.

The Board basically retains enforcement jurisdiction over any institution-affiliated party that leaves an institution, voluntarily or involuntarily, so long as we initiate our cease and desist, removal, prohibition or civil money penalty assessment action within six years of the individual's departure from the institution.

12. 12 U.S.C. 1818 (i)(2) includes many changes to the Board's civil money penalty assessment authority. The statutory bases for the assessment of fines were expanded and the amounts of the potential penalties were increased.

Civil money penalties can be assessed for (a) any violation of law or regulation,[3] (b) any violation of a final cease and desist, temporary cease and desist, suspension, removal or prohibition order, (c) any violation of a condition imposed in writing by the Board in connection with the granting of an application or other request, and (d) any violation of a written agreement.

The amounts of the potential fines vary. The Board can assess a fine of up to $5,000 per day for any of the violations described in the aforementioned paragraph. A fine of up to $25,000 per day can be assessed for any violation set forth above, if the violator (e.g., the financial institution or the institution-affiliated party) recklessly engages in an unsafe or unsound practice in conducting the affairs of the institution, or an individual breaches his or her fiduciary duty, where such violation, practice or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss or results in pecuniary gain or other benefit for the violator. A civil money penalty of up to $1 million per day can be assessed for any violation described in the paragraph above, if the violator knowingly committed the violation, knowingly engaged in the unsafe or unsound practice, or knowingly breached his or her fiduciary duty, and, in so doing, knowingly or recklessly caused a substantial loss to the financial institution or received substantial pecuniary gain or other benefit.

The modified civil money penalty assessment provisions of Title IX of FIRREA apply with respect to conduct engaged in by any person *after* August 9, 1989. There is an exception however—the increased maximum penalties of $5,000 and $25,000 per day may apply to conduct engaged in *before* August 9, 1989, if the conduct is not already subject to a notice issued by the Board *and* the conduct occurred after the completion of the last report of examination of the institution (which examination took place before August 9, 1989).

13. Violations of the Change in Bank Control Act can now be addressed through the same

3. Note that this provision is very broad. The violation of *any* law or regulation that is applicable to a financial institution or an institution-affiliated party subject to the Board's jurisdiction can expose the institution or the individual to a potential civil money penalty.

type of civil money penalty assessment proceedings that are used for all other penalty actions. That is, the requirement that an institution or individual assessed a fine for a violation of the Change in Bank Control Act be granted a full scale trial in a U.S. District Court has been eliminated.

14. The criminal penalties for violations of the Bank Holding Company Act (the "BHC Act") were increased to $100,000 per day for knowingly violating the BHC Act and to $1 million per day in the event that the violations involved an intent to deceive, defraud or profit significantly.

Violations of the BHC Act, which do not rise to the level of criminal offenses, can be addressed through civil money penalty assessments of not more than $25,000 per day.[4]

15. Section 19 of the FDI Act, which prohibits an individual who has been convicted of a felony involving dishonesty or a breach of trust from working for an insured bank without the Federal Deposit Insurance Corporation's approval, was amended to increase the potential fine for a knowing violation of the section to $1 million per day or five years imprisonment. This law now provides that the criminal penalty will apply to both the individual who is employed without the appropriate approval and to the employing institution. Section 19 also applies to a convicted felon's *indirect* involvement with an insured depository institution; therefore, such individuals associated with bank holding companies or their nonbank subsidiaries need to seek FDIC approval of their employment. The Bank Fraud Act has further expanded this prohibition to exclude convicted individuals from serving as an institution-affiliated parties and from owning or controlling, directly or indirectly, an insured depository institution without the FDIC's prior approval.

16. The Bank Protection Act was amended by FIRREA to eliminate the requirement that financial institutions file periodic reports concerning the installation, maintenance and operation of security devices and procedures.

17. Title IX of FIRREA adds new provisions authorizing civil money fines for the submission of false or misleading Call Reports and reports required by the BHC Act and Regulation Y of the Board of Governors. In the event that a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors and an institution unintentionally fails to publish any report or submits any false or misleading report or information or is minimally late with the report, it could be assessed a fine of up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. In the event that the error was not inadvertent, a penalty of up to $20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or one percent of the institution's assets can be assessed for each day of the violation.

Civil money penalties for the submission of late, false or misleading reports or information to the Board relate only to conduct engaged in after the effective date of FIRREA (August 9, 1989).

18. 12 U.S.C. 1818(u) requires that the Board publish and make publicly available any final order issued with respect to any administrative enforcement proceeding initiated by the Board, as well as any modification or termination of such an order. Publication of final enforcement orders and written agreements can only be delayed if the Board makes a determination, in writing, that the publication of any final order would seriously threaten the safety or soundness of an insured depository institution. In the event that the Board can make such a determination, the publication of the final order can be delayed for a "reasonable time". The Bank Fraud Act requires that administrative hearings on the record, including cease and desist, civil money penalty, and suspension, removal and prohibition actions, are to be open to the public.

19. After August 9, 1989, each insured depository institution that was chartered within two years after that date, all financial institutions that have undergone a change in control within two years after that date, and all financial institutions that are not in compliance with the minimum capital adequacy guidelines or regulations of its federal regulator, and each financial institution that is in an otherwise troubled condition must provide 30-days prior written notice to its appropriate federal regulator before the institution can add an individual to its board of directors or employ a senior executive officer.[5]

4. There is an inconsistency between the Board's authority to assess fines of up to $1 million per day for violations of any law or regulation and this $25,000 limitation on the amount of fines under the BHC Act.

5. The banking agencies have issued regulations defining the terms "troubled condition" and "senior executive officer" for the purposes of this law.

The Board, and the other federal financial institutions supervisory agencies, have a 30-day period within which to review each individual's competence, experience, character and integrity; and, in the event that they are not acceptable, the Board or the other agencies, where appropriate, can issue a notice of disapproval of an individual.

20. The federal financial institutions supervisory agencies are required to hire a pool of administrative law judges and to develop uniform rules of procedures for all administrative proceedings within 24 months from August 9, 1989.

21. The correction period afforded to an insured depository institution subject to a termination of federal deposit insurance proceeding initiated by the Federal Deposit Insurance Corporation was reduced to 30 days from 120 days. The Federal Deposit Insurance Corporation is also authorized to issue a temporary suspension of deposit insurance order in the event that it determines, after consultation with the Board or the Office of the Comptroller of the Currency, where applicable, that an insured depository institution has no tangible capital under the capital adequacy guidelines or regulations of the banking agencies.

22. Title IX of FIRREA contains a "whistleblower" protection provision. Under this provision, no insured depository institution may discharge or discriminate against an employee because he or she provided information to a banking agency or to the United States Attorney General (e.g., the Department of Justice, a U.S. Attorney's Office or the Federal Bureau of Investigation) about a possible law violation by the institution or one of its officers, directors or employees. In the event that an institution does discharge or discriminate against such an employee, he or she may sue the institution in U.S. District Court, and the individual must also file a copy of his or her lawsuit with the appropriate banking agency.

23. The federal financial institutions supervisory agencies may, with the concurrence of the United States Attorney General, pay a reward for the provision of information that leads to the recovery of a civil money penalty of in excess of $50,000 (or the forfeiture of property in excess of such an amount). The reward may not exceed 25 percent of the fine or forfeiture or $100,000, whichever is less.

As described above, Title IX of FIRREA contains numerous new or enhanced enforcement powers, as well several significant new responsibilities for the Board and the financial institutions that it supervises. While all of these powers and responsibilities are important, the following enforcement action-related provisions of Title IX are highlighted:

1. All new final enforcement orders and written agreements are to be made public.

2. All new directors and senior executive officers (and all promotions to the senior executive officer level) at financial institutions that were chartered within the last two years (if the institutions are state member banks), underwent a change in control within the last two years, have inadequate capital levels, or are otherwise in a troubled condition will have to file a notice form with the Board and await a 30-day review period before they can be appointed to the board of directors or retained as a senior executive officer.

3. The enforcement powers of the Board are applicable to a broader range of individuals who are associated with the financial institutions that the Board supervises—these include shareholders, attorneys, appraisers, and accountants.

4. The Board's removal and prohibition powers have been clarified in order to enable the continuation (or initiation) of such actions against persons who have left the financial institutions where they engaged in wrongdoing or who were associated with failed state member banks or defunct bank holding companies.

5. Cease and desist orders and written agreements can contain provisions requiring the employment of qualified officers and employees, who can be subject to the prior approval of the Federal Reserve, and they can also contain provisions that place limitations on the functions and activities of an institution or an institution-affiliated party.

6. The bases for the assessment of civil money penalties has been greatly expanded to cover, *inter alia*, all violations of law and regulation.

7. The potential civil money penalty assessment against a financial institution or an institution-affiliated party has been increased substantially—up to $1 million a day under some circumstances.

2110.0.1.2 Statutory Tools Available for Formal Supervisory Action

Including changes resulting from the enactment of FIRREA and the Bank Fraud Act, the following statutory tools are available to the Board of Governors in the event formal supervisory ac-

tion is warranted against a BHC or its nonbank subsidiary or certain individuals associated with either of them. The objective of formal actions is to correct practices that the regulators believe to be unlawful, or unsafe or unsound. The initial consideration and determination of whether formal action is required usually results from the inspection process.

Presented below is information on:

1. Board jurisdiction under the law;
2. Actions or practices that may trigger the statutory remedies;
3. Board staff procedures;
4. The elements of a corrective order;
5. Temporary orders;
6. Written Agreements;
7. Suspensions and removals;
8. Enforcement of orders; and
9. Civil money penalties; and
10. Termination of certain nonbank subsidiary activities or ownership.

2110.0.2 TYPES OF CORRECTIVE ACTIONS

Generally, under 12 U.S.C. 1818(b) the Board may use its cease and desist authority and other enforcement tools against (a) a bank holding company, (b) a nonbank subsidiary of a bank holding company, and (c) any institution-affiliated party, including any director, officer, employee, controlling shareholder (other than a bank holding company), agent, person who has filed or is required to file a change in control notice, consultant, joint venture partner, or other person who participates in the conduct of the affairs of a bank holding company or nonbank subsidiary, and any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in any violation of law or regulation, any breach of fiduciary duty, or any unsafe or unsound practice that causes or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the institution. Cease and desist action may be initiated when there is a finding that an offender is engaging, has engaged or may engage in an unsafe or unsound practice in conducting the business of the institution. An action may also be deemed necessary due to a finding that the offender is violating, has violated or may violate a law, rule or regulation, or any condition imposed in writing by the Board in connection with the granting of any application or any written agreement.

2110.0.2.1 Cease and Desist Orders

When Board staff, in conjunction with the appropriate Federal Reserve Bank, determines that a cease and desist action is necessary, the Board may issue a ‘‘notice of charges and of hearing’’ to the offending institution or person. The notice of charges will contain a statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing starts a formal process that may include the convening of an administrative hearing (within 30–60 days) to be conducted before an Administrative Law Judge, who makes a recommended decision to the Board. At the conclusion of the hearing process and after consideration of the proceeding by the Board, the Board may issue a final cease and desist order. Institutions and individuals who are subject to cease and desist orders that were issued as a result of contested proceedings can appeal the Board’s issuance of the order to federal courts of appeal.

In order to abbreviate the period of litigation, the offending party or institution is permitted an opportunity to ‘‘consent’’ to the issuance of a cease and desist order without the need for the notice and an administrative hearing. Board staff has the option of first drafting a proposed cease and desist order and presenting the matter to the offenders for their ‘‘consent’’ prior to submission of the case to the Board. In the event the parties voluntarily agree to settle the case by the issuance of a consent cease and desist order, the terms of the settlement will be presented to the Board for its ratification and formal issuance of the order at which time the order will be final and binding. Note that BHC personnel should have legal counsel present at all discussions concerning formal corrective actions.

Once issued by the Board, a cease and desist order may require the persons or entity subject to the order to (a) cease and desist from the practices or violations or (b) take affirmative action to correct the violations or practices. Affirmative actions might include returning the holding company to its ‘‘original condition’’ prior to the practice or violation or having an individual reimburse the company for unauthorized or improper payments received or both. Affirmative actions may also include: restitution, reimbursement, indemnification, or guarantee against loss if the person or entity was unjustly enriched by the violation or practice, or the violation or practice involved a reckless disregard for the law or applicable regulations or prior order; restrictions on growth; disposition of any loan or asset; rescission of agree-

ments or contracts; employment of qualified officers or employees; and any other action the Board determines to be appropriate.

12 U.S.C. 1818(b)(3) makes it clear that the cease and desist authority contained in section 8(b) of the Federal Deposit Insurance Act also applies to BHCs and Edge and Agreement Corporations, as well as all institution-affiliated parties associated with them.

2110.0.2.2 Temporary (Emergency) Cease and Desist Orders

In the event that a violation of law, rule or regulation, or the undertaking of an unsafe or unsound practice meets the test that it is likely to cause the insolvency of a subsidiary bank or company, cause the significant dissipation of a subsidiary bank's or BHC's assets or earnings, or weaken the condition of the subsidiary bank or company, or otherwise seriously prejudice the interests of depositors, the Board may issue a temporary (emergency) cease and desist order to effect immediate correction pursuant to 12 U.S.C. 1818(c). The Board may also issue a temporary order if the Board determines that the institution's books and records are so incomplete that the institution's financial condition or the details or purpose of any transaction cannot be determined through the normal supervisory process. The temporary order may require the same corrections as an order issued either on consent or after the full administrative process. Its advantage is that it is effective immediately upon service on the entity or individual. A hearing must be held within 30–60 days, during which time the temporary order stays in effect. Within 10 days of the service of the temporary order, the subject may appeal to a U.S. District Court for relief from the order.

2110.0.2.3 Written Agreements

When circumstances warrant a less severe form of formal supervisory action, a formal written agreement may be used. A written agreement may be with either the Board or with the Reserve Bank under delegated authority (12 C.F.R. 265.2(f)(26)). All written agreements must be approved by the Board's Staff Director of the Division of Banking Supervision and Regulation and the General Counsel. The provisions of a written agreement may relate to any of the problems found at the institution or involving related individuals.

2110.0.2.4 Removal Authority

In addition to its cease and desist authority, the Board is also authorized by 12 U.S.C. 1818(e) to suspend and remove current or former institution-affiliated parties of bank holding companies and their nonbank subsidiaries for certain violations and activities and to prohibit permanently their future involvement with insured depository institutions, BHC's and nonbank subsidiaries. The Board is authorized to issue a written notice of its intention to remove from office or prohibit from further participation (or under certain conditions to suspend immediately), any institution-affiliated party of a BHC whenever:

1. The institution-affiliated party has directly or indirectly:
   a. Committed any violation of law, regulation, or cease and desist order, condition imposed in writing, or any written agreement; or
   b. Engaged in any unsafe or unsound practice; or
   c. Breached a fiduciary duty; *and*
2. The Board determines:
   a. That the institution has suffered or will suffer financial loss or other damage; or
   b. That interests of depositors have been or could be prejudiced by the violation or practice; or
   c. That the institution-affiliated party has received financial gain or other benefit from the violation or practice; and
3. Such violation or practice:
   a. Involves personal dishonesty; or
   b. Demonstrates a willful or continuing disregard for the safety or soundness of the institution.

In the event that an institution-affiliated party's actions warrant immediate attention, the Board is authorized to temporarily suspend the person pending the outcome of the complete administrative process. Note also that an institution-affiliated party presently associated with a BHC may be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, BHC or "other business institution." "Other business institution" is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

12 U.S.C. 1818(g) authorizes the appropriate federal banking agency to suspend from office or prohibit from further participation any

institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under State or Federal law if the continued participation might threaten either the interests of depositors or public confidence in the bank. The suspension can remain in effect until the criminal action is disposed of or until the suspension is terminated by the agency.

2110.0.2.5 Termination of Nonbank Activity

The Board is authorized by 12 U.S.C. 1844(e) to order a bank holding company to terminate certain activities of its nonbank subsidiary (other than a nonbank subsidiary of a bank) or to sell its shares of the nonbank subsidiary. When the Board has reasonable cause to believe that the continuation by a bank holding company of any activity or of ownership or control of any of its nonbank subsidiaries constitutes a serious risk to the: (a) financial safety, (b) soundness or (c) stability of the holding company; *and* the activity, ownership or control is (a) inconsistent with sound banking principles, or (b) inconsistent with the purposes of the Bank Holding Company Act, or (c) inconsistent with the Financial Institutions Supervisory Act of 1966, the Board may order the bank holding company to terminate the activity or sell control of the nonbank subsidiary.

2110.0.2.6 Violations of Final Orders and Written Agreements

When any of the various types of formal enforcement orders discussed above has been violated, the Board may apply to a U.S. District Court for enforcement of the action, and the court may order and require compliance.

Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending institution or its institution-affiliated parties, as the circumstances warrant. The amount of the civil money penalty is the same as that described below in the civil money penalty section.

Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to $1 million or imprisonment for up to five years or both, as well as to a civil money penalty assessment or federal court action.

2110.0.2.7 Civil Money Penalties

The Board may assess civil money penalties against any institution or institution-affiliated party for: (a) any violation of law or regulation, (b) any violation of a final cease and desist, temporary cease and desist, suspension, removal or prohibition order, (c) any violation of a condition imposed in writing by the Board in connection with the granting of an application or other request, and (d) any violation of a written agreement.

The Board can assess a fine of up to $5,000 per day for any of these violations. A fine of up to $25,000 per day can be assessed for any of these violations if the offender recklessly engages in an unsafe or unsound practice in conducting the affairs of the institution, or an individual breaches his or her fiduciary duty, where such violation, practice or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to $1 million per day can be assessed for any of these violations if the offender knowingly committed the violation, knowingly engaged in the unsafe or unsound practice, or knowingly breached his or her fiduciary duty, and, in so doing, knowingly or recklessly caused a substantial loss to the financial institution or received substantial pecuniary gain or other benefit.

The Board may also assess civil money penalties for the submission of any late, false, or misleading reports required by the BHC Act and Regulation Y of the Board of Governors. If a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors and an institution unintentionally fails to publish any report or submits any false or misleading report or information or is minimally late with the report, it can be assessed a fine of up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. In the event that the error was not inadvertent, a penalty of up to $20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or one percent of the institution's assets can be assessed for each day of the violation.

Notwithstanding the above, note that viola-

tions of the BHC Act (with the exception of late, false, or inaccurate report violations described above) may be addressed by the assessment of civil money penalties of not more than $25,000 per day.

2110.0.2.8 Publication

The Board is required to publish and make publicly available any final order issued with respect to any administrative enforcement proceeding initiated by the Board. These orders include: cease and desist, removal, prohibition, and civil money penalties. The Board is also required to publish and make publicly available any written agreement, effective November 29, 1990 or after, or other written statement that may be enforced by the Board.

2110.0.2.9 Public Hearings

All hearings on the record, including contested cease and desist, removal, and civil money penalty proceedings, are open to the public. Transcripts of all testimony and copies of all documents, which could include examination and inspection reports and supporting documents, (except those filed under seal) are made available to the public. These documents could include examiner's workpapers, file memorandums, reports of examination and inspection, and correspondence between a problem institution or wrongdoer and the Federal Reserve Bank. Appropriate actions should always be taken to ensure that all written material prepared in connection with any supervisory matter be accurate and free of insupportable conclusions or opinions.

2110.0.2.10 Subpoena Power

12 U.S.C. 1818(n), which is made applicable to BHCs by 12 U.S.C. 1818(b)(3), and 1844(f), gives the Board the authority to issue subpoenas directly or through its delegated representatives and to administer oaths or take depositions in connection with an examination or inspection. An examiner may find it necessary to apply some of these enforcement powers in order to collect certain information from unwilling sources.

2110.0.2.11 Interagency Notification

Any Federal banking regulatory agency that initiates formal enforcement action against a commercial bank must notify the other Federal financial institution regulatory agencies (including the OTS) that such action is being taken and the Board must take similar steps in connection with actions against bank holding companies, their nonbank subsidiaries, and all institution-affiliated parties. This policy pertains to formal administrative actions taken by the Federal banking agencies pursuant to the Financial Institutions Supervisory Act of 1966, as amended and to informal corrective actions such as Memoranda of Understanding. All such notifications must be in writing and must be transmitted by or received by both the regional and head offices of the agencies.

With respect to Federal-State agency coordination, the Federal Reserve provides the appropriate State supervisory authority with notice of its intent to institute a formal corrective action against a bank holding company. Pursuant to 12 U.S.C. 1818(m), the Federal regulatory agencies are required to provide the appropriate State supervisory authority with notice of their intent to institute a formal corrective action against a State chartered bank. This requirement is made applicable to bank holding companies, their nonbank subsidiaries, and all institution-affiliated parties by 12 U.S.C. 1818(b)(3).

2120.0.1 INTRODUCTION

On January 17, 1978, the three federal bank supervisory agencies issued a joint policy statement to address their concern with regard to the potential for improper payments by banks and bank holding companies in violation of the Foreign Corrupt Practices Act and the Federal Election Campaign Act.

While not widespread, the federal bank supervisory agencies were concerned that such practices could reflect adversely on the banking system and constitute unsafe and unsound banking practices in addition to their possible illegality.

The potential devices for making political payments in violation of the law could include compensatory bonuses to employees, designated expense accounts, fees or salaries paid to officers, and preferential interest rate loans. In addition, political contributions could be made by providing equipment and services without charge to candidates for office. Refer to F.R.R.S. at 3–447.1 and 4–875.

2120.0.2 SUMMARY OF THE FEDERAL ELECTION CAMPAIGN ACT

The Federal Election Campaign Act (FECA), enacted in 1971, was designed to curb potential abuses in the area of federal election financing. In general, FECA regulates the making of campaign contributions and expenditures in connection with primary and general elections to federal offices. Since 1907, federal law has prohibited national banks from making contributions in connection with political elections. FECA does not specifically address the making of contributions and expenditures by banks or other corporations to advocate positions on issues that are the subjects of public referenda. As originally enacted, FECA required disclosure of contributions received or expenditures made; however, amendments to the law in 1974 and 1976 imposed additional limitations on contributions and expenditures as well. The 1974 amendments also established the Federal Election Commission (Commission) to administer FECA's provisions. The Commission is responsible for adopting rules to carry out FECA, for rendering advisory opinions, and for enforcing the Act. The Commission was reorganized as a result of the FECA Amendments of 1976, and it has issued regulations interpreting the statute (11 C.F.R.).

2120.0.3 BANKS AND THE FECA

National banks and other federally chartered corporations are specifically prohibited from making contributions or expenditures in connection with *any* election; other corporations, including banks and bank holding companies, may not make contributions or expenditures in connection with *federal* elections. However, corporations may establish and solicit contributions to "separate segregated funds" to be used for political purposes; these are discussed in greater detail below.

State member banks and bank holding companies may make contributions or expenditures that are consistent with state and local law in connection with state or local elections. Because many states have laws that prohibit or limit political contributions or expenditures by banks, familiarization with applicable state and local laws is a necessity. According to the joint policy statement of the three banking agencies, a political contribution must meet not only the requirement of legality but also the standards of safety and soundness. Thus, a contribution or expenditure, among other things, must be recorded properly on the bank's books, may not be excessive relative to the bank's size and condition, and may not involve self-dealing.

Banks may make loans to political candidates provided the loans satisfy the requirements set out below.

2120.0.4 CONTRIBUTIONS AND EXPENDITURES

The words "contribution" and "expenditure" are defined broadly by FECA and the Commission's regulations to include any loan, advance, deposit, purchase, payment, distribution, subscription or gift of money or anything of value which is made for the purpose of influencing the nomination or election of any person to federal office. The payment by a third party of compensation for personal services rendered without charge to a candidate or political committee is also treated as a contribution by FECA, although the term does *not* include the value of personal services provided by an individual without compensation on a volunteer basis.

Although loans are included in the definitions of contribution and expenditure under FECA, a

specific exemption is provided for bank loans made in the ordinary course of business and in accordance with applicable banking laws and regulations. The Commission's regulations provide, further, that in order for extensions of credit to a candidate, political committee or other person in connection with a federal election to be treated as a loan and not a contribution, they must be on terms substantially similar to those made to non-political debtors and be similar in risk and amount. The regulations also provide that a debt may be forgiven only if the creditor has treated it in a commercially reasonable manner, including making efforts to collect the debt which are similar to the efforts it would make with a non-political debtor. In considering whether a particular transaction is a contribution or a loan, it is expected that a factor would be the extent to which the creditor may have departed from its customary credit risk analysis.

FECA and the implementing regulation permit certain limited payments to candidates or their political committees. For example, payment of compensation to a regular employee who is providing a candidate or political committee with legal or accounting services which are solely for the purpose of compliance with the provisions of the FECA is exempt from the definitions of contribution and expenditure. The Commission's regulations also permit occasional use of a corporation's facilities by its shareholders and employees for volunteer political activity; however, reimbursement to the corporation is required for the normal rental charge for anything more than occasional or incidental use.

2120.0.5 SEPARATE SEGREGATED FUNDS AND POLITICAL COMMITTEES

FECA allows the establishment and administration by corporations of ''separate segregated funds'' to be utilized for political purposes. While corporate monies may not be used to make political contributions or expenditures, corporations may bear the costs of establishing and administering these separate segregated funds, including payment of rent for office space, utilities, supplies and salaries. These costs need not be disclosed under FECA. Commission regulations also permit a corporation to exercise control over its separate segregated fund.

In practice, most corporate segregated funds are administered by a group of corporate personnel, which, if the fund receives any contributions or makes any expenditures during a calendar year, constitutes a ''political committee,'' as defined by FECA. As such, it is required to file a statement of organization with the Commission, to keep detailed records of contributions and expenditures, and to file with the Commission reports identifying contributions in excess of $200 and candidates who are recipients of contributions from the fund.

Solicitation of contributions to corporate segregated funds by political committees must be accomplished within the precise limits established by FECA. All solicitations directed to corporate employees must satisfy the following requirements: (1) the contribution must be entirely voluntary; (2) the employee must be informed of the political purposes of the fund at the time of the solicitation; and (3) the employee must be informed of his right to refuse to contribute without reprisal. Beyond those basic requirements, FECA distinguishes between ''executive and administrative'' personnel and other employees. The former and their families may be solicited any number of times, while the latter and their families may only be solicited through a maximum of two written solicitations per year, and these solicitations must be addressed to the employees at their homes. Solicitations may also be directed to corporate stockholders and their families in the same manner as to executive and administrative personnel.

Although a corporation, or a corporation and its subsidiaries, may form several political committees, for purposes of determining the statutory limitations on contributions and expenditures, all committees established by a corporation and its subsidiaries are treated as one. Thus, the total amount which all political committees of a corporation and its subsidiaries may make to a single candidate is $5,000 in any federal election (provided that the committees are qualified multicandidate committees under FECA).

2120.0.6 INSPECTION OBJECTIVES

1. To determine if the company has made improper or illegal payments in violation of either of these statutes, and regardless of legality, and whether they constitute an unsafe and unsound banking practice.

2. To determine if controls have been established to prevent unproper payments in violation of these statutes.

2120.0.7 INSPECTION PROCEDURES

1. Determine whether the company and its nonbank subsidiaries have a policy prohibiting improper or illegal payments, bribes, kickbacks, or loans covered by either the Foreign Corrupt Practices Act or the Federal Election Campaign Act.

2. Determine how the policy, if any, has been communicated to officers, employees, or agents of the organization.

3. Review any investigation or study performed by, or on behalf of, the board of directors that evaluates policy or operations associated with the advancement of funds in possible violation of the statutes mentioned above. In addition, ascertain whether the organization has been investigated by any other government agency in connection with possible violations of the statutes and, if this is the case, review available materials associated with the investigation.

4. Review and analyze any internal or external audit program employed by the organization to determine whether the internal and external auditors have established appropriate routines to identify improper or illegal payments under the statutes. In connection with the evaluation of the adequacy of any audit program, the examiner should:

a. Determine whether the auditor is aware of the provisions of the Foreign Corrupt Practices Act and the Federal Election Campaign Act and whether audit programs are in place which check for compliance with these laws;

b. Review such programs and the results of any audits; and

c. Determine whether the program directs the auditor to be alert to unusual entries or charges which might indicate that improper or illegal payments have been made to persons or organizations covered by the statutes.

5. Analyze the general level of internal control to determine whether there is sufficient protection against improper or illegal payments being irregularly recorded on the organization's books.

6. Both the examiner and assistants should be alert in the course of their usual inspection procedures for any transactions, or the use of organization services or equipment, which might indicate a violation of the statutes. Examination personnel should pay particular attention to:

a. Commercial and other loans (including participations), which may have been made in connection with a political campaign, to assure that any such loans were made in the ordinary course of business in accordance with applicable laws.

b. Income and expense ledger accounts for unusual entries including unusual debit entries (reductions) in income accounts or unusual credit entries (reductions) in expense accounts, significant deviations from the normal amount of recurring entries, and significant entries from an unusual source, such as a journal entry.

Procedure 7, following here, should only be undertaken in cases in which the examiner believes that there is some sufficient evidence indicating that improper or illegal payments have occurred. Such evidence would justify the implementation of these additional procedures.

7. Verification of audit programs and internal controls.

a. Randomly select charged-off loan files and determine whether any charged-off loans were made to (i) foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices Act, or (ii) persons or organizations covered under the Federal Election Campaign Act.

b. For those significant income and expense accounts on which verification procedures have not been performed: (i) prepare an analysis of the account for the period since the last examination, preferably by month, and note any unusual fluctuations for which explanations should be obtained, and (ii) obtain an explanation for significant fluctuations or any unusual items through discussions with organization personnel and review of supporting documents.

2120.0.8 APPARENT VIOLATIONS OF THE STATUTES

Where violations of law or unsafe and unsound banking practices result from improper payments, the Federal Reserve System should exercise its full legal authority, including cease-and-desist proceedings and referral to the appropriate law enforcement agency for further action, to ensure that such practices are terminated. In appropriate circumstances, the fact that such payments have been made may reflect so adversely on an organization's management as to be a relevant factor in connection with the consideration of applications submitted by the organization.

In addition, the Reserve Bank should forward any information on apparent violations of the Federal Election Campaign Act to the Federal

Election Commission. The Federal Election Commission is authorized to enforce FECA. The Commission may be prompted to investigate possible illegal payments by either a sworn statement submitted by an individual alleging a violation of the law, or on its own initiative based on information it has obtained in the course of carrying out its supervisory responsibilities. When the Commission determines that there is probable cause to believe a violation has occurred or is about to occur, it endeavors to enter into a conciliation agreement with the violator. If, however, it finds probable cause to believe that a willful violation has occurred or is about to occur, it may refer the matter directly to the Department of Justice for possible criminal prosecution, without having first attempted conciliation.

If informal means of conciliation fail, the Commission may begin civil proceedings to obtain relief. Should the Commission prevail, a maximum penalty of a fine equal to the greater of $10,000 or 200 percent of the amount of the illegal payment may be imposed. Knowing and willful violations involving over $1,000 may subject the violator to a fine, up to the greater of $25,000 or 300 percent of the illegal payment, and imprisonment for up to one year.

2120.0.9 ADVISORY OPINIONS

Any person, including a bank or a corporation, may request an advisory opinion concerning the application of FECA or of the Commission's regulations to a specific transaction or activity in which that person wishes to engage. The Commission must render such advisory opinion within 60 days from receipt of a complete request. Banks or bank employees wishing to engage in activity which may be regulated by FECA are encouraged to request advisory opinions from the Commission.

Techniques, practices, and tools for credit-risk management are evolving rapidly, as are the challenges that banking organizations face in their business-lending activities. For larger institutions, the number and geographic dispersion of their borrowers make it increasingly difficult for such institutions to manage their loan portfolios simply by remaining closely attuned to the performance of each borrower. As a result, one increasingly important component of the systems for controlling credit risk at larger institutions is the identification of gradations in credit risk among their business loans, and the assignment of internal credit-risk ratings to loans that correspond to these gradations.[1] The use of such an internal rating process is appropriate and necessary for sound risk management at large institutions. See SR-98-25.

Certain elements of internal rating systems are necessary to support sophisticated credit-risk management. Supervisors and examiners, both in their on-site inspections and other contacts with banking organizations, need to emphasize the importance of development and implementation of effective internal credit-rating systems and the critical role such systems should play in the credit-risk-management process at sound large institutions. See SR-98-18 with regard to lending standards for commercial loans.

Internal rating systems are currently being used at large institutions for a range of purposes. At one end of this range, they are primarily used to determine approval requirements and identify problem loans. At the other end, they are an integral element of credit-portfolio monitoring and management, capital allocation, the pricing of credit, profitability analysis, and the detailed analysis to support loan-loss reserving. Internal rating systems being used for these latter purposes should be significantly richer and more robust than systems used for the purposes such as approval requirements and identifying problem loans.

As with all material financial institutional activities, a sound risk-management process should adequately illuminate the risks being taken. It should also cause management to initiate and apply appropriate controls that will allow the institution to balance risks against returns. Furthermore, the process should provide information as to the institution's overall appetite for risk, giving due consideration to the uncertainties faced by lenders and the long-term viability of the institution. Accordingly, large banking organizations should have strong risk-rating systems which should take proper account of gradations in risk. They should also consider (1) the overall composition of portfolios in originating new loans, (2) assessing overall portfolio risks and concentrations, and (3) reporting on risk profiles to directors and management. Moreover, such rating systems should also play an important role in (1) establishing an appropriate level for the allowance for loan and lease losses, (2) conducting internal analyses of loan and relationship profitability, (3) assessing capital adequacy, and possibly (4) administering performance-based compensation.

Examiners should evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing both asset quality and the overall strength of risk management at large institutions. Recognizing that a strong risk-rating system is an important element of sound credit-risk management for such institutions, examiners should specifically evaluate the adequacy of internal risk-rating systems at large institutions as one factor in determining the strength of credit-risk management. In doing so, examiners should be cognizant that an internal risk-identification and -monitoring system should be consistent with the nature, size, and complexity of the banking organization's activities.

2122.0.1 APPLICATION TO LARGE BANK HOLDING COMPANIES

The guidance provided in this section should be applied to all "large" bank holding companies. For this purpose, examiners should treat an institution as being "large" if its lending activities are sufficient in scope and diversity such that informal processes that rely on keeping track of the condition of individual borrowers are inadequate to manage its loan portfolio. In this context, those institutions with significant involvement in relevant secondary-market credit activities, such as securitization of business loans or credit derivatives, should have more elaborate and formal approaches for managing

1. For information on current practices in risk rating among large banking organizations, see "Credit Risk Rating at Large U.S. Banks," *Federal Reserve Bulletin*, November 1998, pp. 897–921.

the risks associated with these activities.[2] Whether or not they are active in such secondary-market credit activities, however, larger and complex institutions typically would require a more structured and sophisticated set of arrangements for managing credit risk than smaller regional or community institutions. In performing their evaluation, examiners should also consider whether other elements of the risk-management process might compensate for any specific weaknesses attributable to an inadequate rating system.

In addition, examiners should review internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of risk management or capital at the institution. Examiners should also consider whether a significant shift toward higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, should have negative implications for the institution's asset-quality rating, including the adequacy of the loan-loss reserve. To some extent, such reviews are already an informal part of the current inspection process. Examiners should also continue the long-standing practice of evaluating trends in categories associated with problem assets.

Examiners should discuss these issues, including plans to enhance existing credit-rating systems, with bank management and directors. Inspection comments on the adequacy of risk-rating systems and the credit quality of the pass portfolio should be incorporated within the inspection report, noting deficiencies where appropriate.

2122.0.2 SOUND PRACTICES IN FUNCTION AND DESIGN OF INTERNAL RATING SYSTEMS

A consistent and meaningful internal risk-rating system is a useful means of differentiating the degree of credit risk in loans and other sources of credit exposure. This consistency and meaning is rooted in the design of the risk-grading system itself. Although assigning such risk ratings—as with ratings issued by public rating agencies—necessarily involves subjective judgment and experience, a properly designed rating system will allow this judgment to be applied in a structured, more or less formal manner.

Credit-risk ratings are designed to reflect the quality of a loan or other credit exposure, and thus, explicitly or implicitly, the loss characteristics of that loan or exposure. Increasingly, large institutions link definitions to one or more measurable outcomes such as the probability of a borrower's default or expected loss (which couples the probability of default with some estimate of the amount of loss to be incurred in the event a default occurs). In addition, credit-risk ratings may reflect not only the likelihood or severity of loss but also the variability of loss over time, particularly as this relates to the effect of the business cycle. Linkage to these measurable outcomes gives greater clarity to risk-rating analysis and allows for more consistent evaluation of performance against relevant benchmarks. The degree of linkage varies among institutions, however.

Although the degree of formality may vary, most institutions distinguish the risks associated with the borrowing entity (essentially default risk) from the risks stemming from a particular transaction or structure (more oriented to loss in event of default). In documenting their credit-administration procedures, institutions should clearly identify whether risk ratings reflect the risk of the borrower or the risk of the specific transaction. In this regard, many large institutions currently assign both a borrower and facility rating, requiring explicit analysis of both the loan's obligor and how the structure and terms of the particular loan being evaluated (that is, collateral or guarantees) might strengthen or weaken the quality of the loan.

The rating scale chosen should meaningfully distinguish gradations of risk within the institution's portfolio so that there is clear linkage to loan quality (and/or loss characteristics), rather than just to levels of administrative attention.[3]

2. Secondary-market credit activities generally include loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. Such activities are described further in section 2129.05 and in SR-97-21.

3. See the December 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses in section 2010.7. The policy does not apply to bank holding companies directly. As they supervise their respective FDIC-insured financial institution subsidiaries, bank holding companies are advised to apply this supervisory guidance. Internal risk-rating systems and/or supporting documentation should be sufficient to enable examiners to reconcile the totals for the various internal risk ratings under the institution's system to the federal banking agencies' categories for those loans graded below "pass" (that is, loans classified as special mention, substandard, doubtful, or loss).

To do so, the rating system should be designed to address the range of risks typically encountered in the underlying businesses involving the institution's loan portfolio. One reflection of this degree of meaning is that there should be a fairly wide distribution of portfolio outstandings or exposure across grades, unless the portfolio is genuinely homogeneous. Many current rating systems include grades intended solely to capture credits needing heightened administrative attention, such as so-called "watch" grades. Prompt and systematic tracking of credits in need of such attention is an essential element of managing credit risk. However, to the extent that loans in need of attention vary in the risk they pose, isolating them in a single grade may detract from that system's ability to indicate risk. One alternative is the use of separate or auxiliary indicators for those loans needing such administrative attention.

Institutions whose risk-rating systems are least effective in distinguishing risk use them primarily to identify loans that are classified for supervisory purposes or that bank management otherwise believes should be given increased attention (that is, "watch" loans). Such systems contribute little or nothing to evaluating the bulk of loans in the portfolio—that is, loans for which no specific difficulties are present or foreseen. In some cases these institutions might also establish one or two risk grades for loans having very little perceived risk, such as those collateralized by cash or liquid securities or those to "blue-chip" private firms. Although the foregoing gradations are well-defined in terms of the relative credit risk they represent, the consequence for these least effective systems is that the bulk of the loan portfolio falls into one or two remaining broad risk grades—representing "pass" loans that are neither extremely low risk nor current or emerging problem credits—even though such grades may encompass many different levels of underlying credit risk.

2122.0.3 SOUND PRACTICES IN ASSIGNING AND VALIDATING INTERNAL RISK RATINGS

Experience and judgment, as well as more objective elements, are critical both in making the credit decision and in assigning internal risk grades. Institutions should provide clear and explicit criteria for each risk grade in their credit policies, as well as other guidance to promote consistency in assigning and reviewing grades. Criteria should be specified, even when addressing subjective or qualitative considerations, that allow for consistent assignment of risk grades to similarly risky transactions. Such criteria should include guidance both on the factors that should be considered in assigning a grade and how these factors should be weighed in arriving at a final grade.

Such criteria can promote consistency in assessing the financial condition of the borrower and other objective indicators of the risk of the transaction. One vehicle for enhancing the degree of consistency and accuracy is the use of "guidance" or "target" financial ratios or other objective indicators of the borrower's financial performance as a point of comparison when assigning grades. Banking organizations may also provide explicit linkages between internal grades and credit ratings issued by external parties as a reference point, for example, senior public debt ratings issued by one or more major ratings agencies. The use of default probability models, bankruptcy scoring, or other analytical tools can also be useful as supporting analysis. However, the use of such techniques requires institutions to identify the probability of default that is "typical" of each grade. The borrower's primary industry may also be considered, both in terms of establishing the broad characteristics of borrowers in an industry (for example, degree of vulnerability to economic cycles or long-term favorable or unfavorable trends in the industry) and of a borrower's position within the industry.

In addition to quantitative indications and tools, credit policies and ratings definitions should also cite qualitative considerations that should affect ratings. These might include factors such as (1) the strength and experience of the borrower's management, (2) the quality of financial information provided, and (3) the access of the borrower to alternative sources of funding. Addressing qualitative considerations in a structured and consistent manner when assigning a risk rating can be difficult. It requires experience and business judgment. Nonetheless, adequate consideration of these factors is important to assessing the risk of a transaction appropriately. In this regard, institutions may choose to cite significant and specific points of comparison for qualitative factors in describing how such considerations can affect the rating (for example, whether a borrower's financial statements have been audited or merely compiled by its accountants, or whether collateral has been independently valued).

Although the rating process requires the exercise of good business judgment and does not

lend itself to formulaic solutions, some formalization of the process can be helpful in promoting accuracy and consistency. For example, the use of a ''risk-ratings analysis form'' can be important (1) in providing a clear *structure* for identifying and addressing the relevant qualitative and quantitative elements to be considered in determining internal risk grades, and (2) for *documenting* how those grades were set by requiring analysis or discussion of key quantitative and qualitative elements of a transaction.

Risk ratings should be reviewed, if not assigned, by independent credit-risk management or loan-review personnel both at the inception of a transaction and periodically over the life of the loan.[4] Such independent reviewers should reflect a level of experience and business judgment that is comparable to that of the line staff responsible for assigning and reviewing initial risk grades. Among the elements of such independent review should be whether risk-rating changes (and particularly downgrades) have been timely and appropriate. Such independent reviews of individual ratings support the discipline of the rating assignments by allowing management to evaluate the performance of those individuals assigning and reviewing risk ratings. If an institution relies on outside consultants, auditors, or other third parties to perform all or part of this review role, such individuals should have a clear understanding of the institution's ''credit culture'' and its risk-rating process, in addition to commensurate experience and competence in making credit judgments.

Finally, institutions should track performance of grades over time to gauge migration, consistency, and default/loss characteristics to allow for evaluation of how well risk grades are being assigned. Such tracking also allows for *ex post* analysis of the loss characteristics of loans in each risk grade.

Because ratings are typically applied to different types of loans—for example, to both commercial real estate and commercial loans—it is important that each grade retains the same meaning to the institution (in terms of overall risk) across the exposure types. Such comparability allows management to treat loans in high-risk grades as a potential concentration of credit risk and to manage them accordingly. It also allows management and supervisors to monitor the overall degree of risk, and changes in the risk makeup, of the portfolio. Such consistency further permits risk grades to become a reliable input into portfolio credit-risk models.[5]

2122.0.4 APPLICATION OF INTERNAL RISK RATINGS TO INTERNAL MANAGEMENT AND ANALYSIS

As noted earlier, robust internal credit-rating systems are an important element in several key areas of the risk-management process. Although nearly all large institutions currently use risk ratings, many of the institutions need to further develop these systems so that they provide accurate and consistent indications of risk and sufficient granularity—finer distinctions among risks, especially for riskier assets. Described below are approaches to risk management and analysis that are based on robust internal risk-rating systems and that are currently being used at some banking organizations. These techniques appear to be emerging as sound practices in the use of risk ratings.

2122.0.4.1 Limits and Approval Requirements

Many large institutions have different approval requirements and thresholds for different internal grades, allowing less scrutiny and greater latitude in decision making for loans with lesser risk.[6] While this appears reasonable, institutions should also consider whether the degree of eased approval requirements (or the degree to which limits are higher) is supported by the degree of reduced risk and uncertainty associated with these lower-risk loans. If not, lesser requirements may provide incentives to rate loans too favorably, particularly in the current benign economic environment, with resulting underassessment of transaction risks.

2122.0.4.2 Reporting to Management on Credit-Risk Profile of the Portfolio

As part of reports that analyze the overall credit risk in the institution's portfolio, management

4. See section 2010.10 regarding internal loan review.

5. For a discussion of these models and the role played by internal credit-risk ratings, see the May 1998 Federal Reserve System report, ''Credit Risk Models at Major U.S. Banking Institutions: Current State of the Art and Implications for Assessments of Capital Adequacy,'' prepared by the Federal Reserve System Task Force on Internal Credit-Risk Models.

6. See section 2160.0 for more general guidance involving risk evaluation and control.

and directors should receive information on the profile of actual outstanding balances, exposures, or both by internal risk grade.[7] Such information can thus be one consideration among others, such as concentrations in particular industries or borrower types, in evaluating an institution's appetite for originating various types of new loans. Portfolio analysis may range from simple tallies of aggregates by risk grade to a formal model of portfolio behavior that incorporates diversification and other elements of the interaction among individual loan types. In this more complex analysis, gradations of risk reflect only one among many dimensions of portfolio risk, along with potential industry concentrations, exposure to an unfavorable turn in the business cycle, geographical concentrations, and other factors.

2122.0.4.3 Allowance for Loan and Lease Losses

The makeup of the loan portfolio and the loss characteristics of each grade—including individual pass grades—should be considered, along with other factors, in determining the adequacy of an institution's allowance for loan and lease losses.[8]

2122.0.4.4 Pricing and Profitability

In competitive marketplaces, it is properly the role of bankers rather than supervisors to judge the appropriateness of pricing, particularly with regard to any single transaction or group of transactions. One way that some institutions choose to discipline their overall pricing practices across their portfolio is by incorporating risk-rating-specific loss factors in the determination of the minimum profitability requirements (that is, ''hurdle rates''). Following this practice may render such institutions less likely to price loans well below the level indicated by the long-term risk of the transaction. Given that bank lending, particularly pricing, can be highly competitive, the application of appropriate disciplines to pricing, in conjunction with a clear and meaningful assessment of the risks inherent in each transaction and in the portfolio as a whole, can be important tools in avoiding competitive future excessive practices.

2122.0.4.5 Internal Allocation of Capital

Those institutions that choose to allocate capital may use their internal risk grades as important inputs in identifying appropriate internal capital allocations. Use of appropriately allocated capital in evaluating profitability offers many advantages, including the incentive to consider both risk and return in making lending decisions rather than merely rewarding loan volume and short-term fee revenue. Under appropriate circumstances—that is, where internal capital allocations are sufficiently consistent, rigorous, and well-documented—such allocations may also be considered as a source of input for supervisory evaluations of capital adequacy.[9]

2122.0.5 INSPECTION OBJECTIVES

1. To evaluate whether the internal risk-identification and -monitoring systems are consistent with—
   a. sound practices in the function and design of internal rating systems;
   b. sound practices in assigning and reviewing internal risk ratings; and
   c. the nature, size, and complexity of activities within the banking organization.
2. To determine whether the level and volume of lower-quality pass grades of loans have grown significantly over time and whether any such trends should—
   a. have adverse implications for determining the adequacy of risk management and capital, and
   b. materially alter the institution's asset-quality ratings and valuations, and the examiner's evaluation of the adequacy of the allowance for loan and lease losses.
3. To determine whether improvements are needed in the credit-risk-management process and to discuss them with the board of directors and senior management.
4. To document the extent to which the institution has adopted current and emerging sound

7. See section 2010.2 regarding a bank holding company's supervision of its subsidiaries and loan administration. See also the more general financial analysis sections 4020.2 and 4060.1 with regard to evaluating the asset quality of subsidiary financial institutions and evaluating the asset quality of the holding company on a consolidated basis.

8. See footnote 3. Section 2010.7 emphasizes the bank holding company's responsibility as it supervises its subsidiaries with respect to each entity maintaining an adequate allowance for loan and lease losses.

9. See sections 4060.3 and 4060.4 regarding the evaluation of capital adequacy of bank holding companies.

practices in the use of internal ratings information in internal risk management and analysis.

5. To incorporate the examiner's evaluation of sound credit-risk-rating practices into the assessment of management and capital adequacy.

2122.0.6 INSPECTION PROCEDURES

1. Determine whether the institution is considered "large" for purposes of applying this section's guidance and procedures.
2. Evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing the quality and overall strength of risk management. Give particular attention to the following practices:
   a. *Function and design of internal rating systems.*
      - Ascertain whether the rating scale meaningfully distinguishes gradations of risk within the institution's portfolio evidencing clear linkage to loan quality and/or loss characteristics.
        — Determine if the design of the rating system has an adequate number of internal ratings to distinguish among levels of risks in its portfolio, and whether the grades used address the range of risks typically encountered in the underlying businesses of the institution.
        — Determine whether loans or exposures are broadly distributed across the internal grades.
        — Establish if there are "watch grades" that are intended to capture loans needing heightened administrative attention, or whether separate or auxiliary indicators are used for such loans.
      - Determine whether credit-risk-rating definitions are linked to one or more measurable outcomes (for example, the probability of a borrower's default or expected loss).
   b. *Sound practices in assigning internal risk ratings.*
      - Determine whether loan policies provide clear and explicit criteria for each risk grade as to the risk factors that are to be considered in assigning a grade with respect to—
        — financial analysis, including whether reference financial ratios or other objective indicators are used to indicate the borrower's financial performance;
        — explicit linkages between the internal grades assigned and credit ratings issued by external parties (for example, senior public debt ratings by major rating agencies);
        — default probability models, bankruptcy scoring, or other analytical tools used;
        — analysis of a borrower's primary industry, considering both the broad characteristics of borrowers within that industry and the borrower's position within that industry; and
        — qualitative factors (for example, the quality of the financial information that is provided, the borrower's access to alternative sources of funding, whether the financial statements were audited or merely compiled, or whether collateral was independently valued).
      - Determine whether loan policies provide clear and explicit guidance as to how these risk factors should be weighed in arriving at a final grade.
      - Determine whether the ratings assignment is well documented, possibly including the use of a risk-rating form to provide formalization and standardization of the quantitative and qualitative criteria elements used in rating borrowers and/or transactions.
      - Establish whether risk ratings are independently reviewed at the inception of a loan and periodically over the life of a loan, and whether risk-rating changes have been timely and appropriate (particularly downgrades).
      - Ascertain whether the performance of rating grades is tracked over time to evaluate migration, consistency, and default/loss characteristics and trends.
   c. *Application of internal risk ratings to internal management and analysis.*
      - Determine whether loan-approval requirements for each grade appear to be supported by the degree of risk and uncertainty associated with the respective loans.
      - Review internal management information system reports and determine

whether such reporting is adequate for the institution.

- Ascertain if the risk-rating-specific loss factors are used to determine risk pricing, minimum profitability requirements, and capital adequacy needs, and document the institution's progress in this regard.

3. Determine whether other risk elements may compensate for any specific weaknesses attributable to an inadequate rating system.
4. Review internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of risk management or capital at the institution.
5. Determine whether a significant shift toward higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, should have negative implications for the institution's asset-quality rating, including the adequacy of the loan-loss reserve.
6. Evaluate trends in risk-rating categories associated with problem assets.
7. Discuss the results of the evaluations with management, including whether there are any plans to enhance existing credit-rating systems.
8. Prepare written comments for the inspection report on the adequacy of risk-rating systems and the credit quality of the pass portfolio, noting any deficiencies.

Full-scope inspections under a risk-focused approach must be performed to fulfill the objectives of a full-scope inspection, adjusted depending on the circumstances of the banking organization being evaluated. At a minimum, full-scope inspections should include sufficient procedures to reach an informed judgment on the assigned ratings for the factors addressed by the BOPEC rating system. The business of banking is fundamentally predicated on taking risks, and the components of the supervisory rating system are strongly influenced by risk exposure. Consequently, the procedures of full-scope inspections focus to a large degree on assessing the types and extent of risks to which a bank holding company and its subsidiaries are exposed, evaluating the organization's methods of managing and controlling its risk exposures, and ascertaining whether management and directors fully understand and are actively monitoring the organization's exposure to those risks. Given the Federal Reserve's responsibility for ensuring compliance with banking laws and regulations, inspections also include an appropriate level of compliance testing. (See SR-96-14.)

2124.0.1 TRANSACTION TESTING

Historically, Federal Reserve examinations and inspections have placed significant reliance on transaction-testing procedures. For example, to evaluate the adequacy of the credit-administration process, assess the quality of loans, and ensure the adequacy of the allowance for loan and lease losses (ALLL), a high percentage of large loan amounts have traditionally been individually reviewed. Similarly, the assessment of the accuracy of regulatory reporting often has involved extensive review of reconciliations of a bank holding company's general ledger to the FR Y-9C report and other FR Y-series reports. Other similar procedures typically have been completed to ascertain compliance with applicable laws and regulations, to determine whether the banking and nonbank subsidiaries are following their internal policies and procedures and those of the bank holding company, and to evaluate the adequacy of internal control systems.

Transaction testing remains a reliable and essential inspection technique for assessing a banking organization's condition and verifying its adherence to internal policies, procedures, and controls. In a highly dynamic banking market, however, such testing is not sufficient for ensuring continued safe and sound operations. As evolving financial instruments and markets have enabled banking organizations to rapidly reposition their portfolio risk exposures, periodic assessments of the condition of banking organizations based on transaction testing alone cannot keep pace with the moment-to-moment changes occurring in financial risk profiles.

To ensure that banking organizations have in place the processes necessary to identify, measure, monitor, and control their risk exposures, inspections must focus more on evaluating the appropriateness of a very high degree of transaction testing. Under a risk-focused approach, the degree of transaction testing should be reduced when internal risk-management processes are determined to be adequate or risks are considered minimal. However, when an organization's risk-management processes or internal controls are considered inappropriate (such as when there is an inadequate segregation of duties or when on-site testing determines that such processes or controls are lacking), additional transaction testing sufficient to fully assess the degree of risk exposure in that function or activity must be performed. In addition, if an examiner believes that a banking organization's management is being less than candid, has provided false or misleading information, or has omitted material information, then substantial on-site transaction testing should be undertaken and appropriate follow-up actions should be initiated, including the requirement of additional audit work and appropriate enforcement actions.

In most cases, full-scope inspections are conducted on or around a single date. This is appropriate for the vast majority of banking organizations supervised by the Federal Reserve. However, as the largest banking organizations have undergone considerable geographic expansion and the range of their products has become more diversified, coordinating the efforts of the large number of examiners necessary to conduct inspections at a single point in time has become more difficult. To avoid causing undue burden on these banking organizations, full-scope inspections for many large companies are conducted over the course of a year, rather than over a span of weeks, in a series of targeted reviews focusing on one or two significant aspects of the bank holding company's operations. This approach to conducting full-scope

inspections provides more continuous supervisory contact with the largest bank holding companies and can facilitate improved coordination of inspection efforts with other federal banking agencies. It also provides more flexibility in the allocation of examiner resources, which has been especially important as the complexity of banking markets and products has increased and has led to the development of cadres of examiners with specialized skills.

2124.0.2 RISK-FOCUSED INSPECTIONS

Developments in the business of banking have increased the range of banking activities, heightening demands on examiner resources and making the need for examiners to effectively focus their activities on areas of the greatest risk even more crucial. Improved in-office planning can result in more efficient and effective on-site inspections that are focused on risks particular to specific organizations of the bank holding company. Such improved planning minimizes supervisory burden and provides for the close coordination of the supervisory efforts of the Federal Reserve with those of the other state and federal banking agencies. Improved planning also allows information requests to be better tailored to the specific organizations.

2124.0.2.1 Risk Assessment

To focus procedures on the areas of greatest risk, a risk assessment should be performed before on-site supervisory activities. The risk-assessment process highlights both the strengths and vulnerabilities of a bank holding company and provides a foundation from which to determine the procedures to be conducted during an inspection. Risk assessments indentify the financial activities in which a banking organiation has chosen to engage, determine the types and quantities of risks to which these activities expose the organization, and consider the quality of management and control of these risks. At the conclusion of the risk-assessment process, a preliminary supervisory strategy can be formulated for the bank holding company and its subsidiaries and each of their major activities. Naturally, those activities that are most significant to the organization's risk profile or that have inadequate risk-management processes or rudimentary internal controls represent the highest risks and should undergo the most rigorous scrutiny and testing.

Identifying the significant activities of a bank holding company, including those conducted off-balance-sheet, should be the first step in the risk-assessment process. These activities may be identified through the review of prior bank examination and bank holding company inspection reports and workpapers, surveillance and monitoring reports generated by Board and Reserve Bank staffs, Uniform Bank Performance Reports and Bank Holding Company Performance Reports, regulatory reports (for example, bank call reports and the FR Y-9C and FFIEC 002 reports), and other relevant supervisory materials. Where appropriate, conduct reviews of strategic plans and budgets, internal management reports, board of directors information packages, correspondence and minutes of meetings between the bank holding company and the Reserve Bank, annual reports and quarterly SEC filings, press releases and published news stories, and stock analysts' reports. In addition, examiners should hold periodic discussions with management to gain insight into their latest strategies or plans for changes in activities or management processes.

Once significant activities have been identified, the types and quantities of risks to which these activities expose the bank holding company should be determined. This allows identification of the high-risk areas that should be emphasized in conducting inspections. The types of risk that may be encountered in banking activities individually or in various combinations include, but are not limited to, credit, market, liquidity, operational, legal, and reputational risks.[1] For example, lending activities are a primary source of credit and liquidity risks. They may also present considerable market risk (if the bank holding company or its subsidiaries are originating mortgage loans for later resale), interest-rate risk (if fixed-rate loans are being granted), or legal risk (if loans are poorly documented). Similarly, the asset/liability management function has traditionally been associated with exposures to interest-rate and liquidity risks. There are also operational risks associated with many of the transactions undertaken by this function, and with other market risks associated with the investments and hedging instruments commonly used by the asset/liability management function. The quantity of risks associated with a given activity may be indi-

1. Appendix A defines these primary risk types.

cated by the volume of assets and off-balance-sheet items that the activity represents or by the portion of revenue for which the activity accounts. Activities that are new to an organization or for which exposure is not readily quantified may also represent high risks that should be evaluated at inspections.

A number of analytical techniques may be used to estimate the quantity of risk exposure, depending on the activity or risk type being evaluated. For example, to assess the quantity of credit risk in loans and commitments, the level of past-due loans, internally classified or watch-list loans, nonperforming loans, and concentrations of credit exposure to particular industries or geographic regions should be considered (see section 2010.2). In addition, as part of the assessment of credit risk, the adequacy of the overall ALLL can be evaluated by considering trends in past-due, special-mention, and classified loans; historic charge-off levels; and the coverage of nonperforming loans by the ALLL. Analytical techniques for gauging the exposure of a bank holding company and its subsidiaries to interest-rate risk, as part of the evaluation of asset/liability management practices, can include a review of the historic performance of net interest margins, as well as the results of internal projections of future earnings performance or net economic value under a variety of plausible interest-rate scenarios. The measurement of the quantity of market risk arising from trading in cash and derivative instruments may take into account the historic volatility of trading revenues, the results of internal models calculating the level of capital and earnings at risk under various market scenarios, and the market value of contracts relative to their notional amounts.

Once the types and quantities of risk in each activity have been identified, a preliminary assessment of the banking organization's process to identify, measure, monitor, and control these risks should be completed. This evaluation should be based on findings from previous examination and inspection activities conducted by the Reserve Bank or other banking agencies, supplemented by the review of internal policies and procedures, management reports, and other documents that provide information on the extent and reliability of internal risk-management systems. Sound risk-management processes vary from one banking organization to another, but generally include four basic elements for each individual financial activity or function and for the organization in aggregate. These elements are (1) active board and senior management oversight; (2) adequate policies, procedures, and limits; (3) adequate risk-measurement, monitoring, and management information systems; and (4) comprehensive internal audits and controls. (See section 4070.1 and SR-95-51.)

The preliminary evaluation of the risk-management process for each activity or function also helps determine the extent of transaction testing that should be planned for each area. If the organization's risk-management process appears appropriate and reliable, then a limited amount of transaction testing may well suffice. If, on the other hand, the risk-management process appears inappropriate or inadequate to the types and quantities of risk in an activity or function, examiners should plan a much higher level of transaction testing. They should also plan to conduct the most testing in those areas that comprise the most significant portions of a bank holding company's activities and, thus, typically represent high potential sources of risk.

2124.0.2.2 Preparation of a Scope Memorandum

Once the inspection planning and risk-assessment processes are completed, a scope memorandum should be prepared. A scope memorandum provides a detailed summary of the supervisory strategy for a bank holding company and assigns specific responsibilities to inspection team members. A scope memorandum should be tailored to the size and complexity of the bank holding company that is subject to review, define the objectives of each inspection, and generally include—

- a summary of the results of the prior inspection;
- a summary of the strategy and significant activities of the banking organization, including its new products and activities;
- a description of the bank holding company's organization and management structure;
- a summary of performance since the prior inspection;
- a statement of the objectives of the current inspection;
- an overview of the activities and risks to be addressed by the inspection; and
- a description of the procedures that are to be performed at the inspection.

For large, complex organizations operating in a number of states or internationally, the planning and risk-assessment processes are necessarily more complicated. The traditional scope memorandum may have to be broadened into a more extensive set of planning documents to reflect the unique requirements of complex bank holding companies. Examples of these planning documents include annual consolidated analyses, periodic risk assessments, and supervisory plans.

2124.0.2.3 On-Site Procedures

The amount of review and transaction testing necessary to evaluate particular functions or activities of a bank holding company generally depend on the quality of the process the company uses to identify, measure, monitor, and control the risks of an activity. When the risk-management process is considered sound, further procedures are limited to a relatively small number of tests of the integrity of the management system. Once the integrity of the management system is verified through limited testing, conclusions on the extent of risks within the function or activity are drawn based on internal management assessments of those risks rather than on the results of more extensive transaction testing by examiners. On the other hand, if initial inquiries into the risk-management system—or efforts to verify the integrity of the system—raise material doubts as to the system's effectiveness, no significant reliance should be placed on the system. A more extensive series of tests should be undertaken to ensure that the banking organization's exposure to risk from a given function or activity can be accurately gauged and evaluated. More extensive transaction testing is also generally completed for activities that are much more significant to a bank holding company than for other areas, although the actual level of testing for these significant activities may be reduced commensurate with the quality of internal risk-management processes.

Consider, as an example, the risk exposure associated with commercial lending activities whereby examiners have traditionally reviewed a relatively high number and dollar volume of real estate–associated loans.[2] If, however, credit-administration practices are considered satisfactory, fewer loans may need be reviewed to verify that this is the case (that is, fewer loans than would be reviewed if deficiencies in credit-administration practices were suspected). This review may be achieved through a valid statistical sampling technique, when appropriate. It should be noted that if credit-administration practices are initially considered sound, but loans reviewed to verify this raise doubts about the accuracy of internal assessments or the compliance with internal policies and procedures, the number and volume of loans subject to review should generally be expanded. Examiners should thus review a sufficient number of loans to ensure that the level of risk is clearly understood, an accurate determination of the adequacy of the ALLL can be made, and the deficiencies in the credit risk-management process can be comprehensively detailed.

2124.0.2.4 Evaluation of Audit Function as Part of Assessment of Internal Control Structure

A bank holding company's internal control structure is critical to its safe and sound functioning in general and to its risk-management system in particular. When properly structured, internal controls promote effective operations and reliable financial and regulatory reporting; safeguard assets; and help to ensure compliance with laws, regulations, and internal policies and procedures. In many banking organizations, internal controls are tested by an independent internal auditor who reports directly to the board of directors or its audit committee. However, in some smaller banking organizations whose size and complexity of operations do not warrant an internal audit department, reviews of internal controls may be conducted by other personnel independent of the area subject to review.

Because the audit function is an integral part of a bank holding company's assessment of its internal control system, examiners must include a review of the organization's control-assessment activities in every inspection. Such reviews help identify significant risks and facilitate a comprehensive evaluation of the organization's internal control structure and also provide information to determine the inspection procedures that should be completed in assessing internal controls for particular functions and activities and for the bank holding company overall. When conducting this review, examin-

2. Guidance on the selection of loans for review is provided in SR-94-13, ''Loan Review Requirements for On-Site Examinations.''

ers should evaluate the independence and competence of the personnel conducting control assessments and the effectiveness of the assessment program in covering the bank holding company's significant activities and risks. In addition, examiners should meet with the internal auditors or other personnel responsible for evaluating internal controls and review internal control risk assessments, work plans, reports, workpapers, and related communications with the audit committee or board of directors.

Depending on the size and complexity of the activities conducted by a bank holding company, the examiner should also consider conducting a similar review of the work performed by the company's external auditors. Such a review often provides added insight into key risk areas by detailing the nature and extent of the external auditors' testing of those areas.

2124.0.2.5 Evaluation of Overall Risk-Management Process

To highlight the importance of a banking organization's risk-management process, bank holding companies are assigned a risk-management rating on a five-point scale as a significant part of the evaluation of the management components of the BOPEC rating systems (see section 4070.1). In addition, U.S. branches and agencies of foreign banking organizations are assigned a similar rating under the ROCA rating system.[3] These risk-management ratings encompass evaluations of the quality of risk-management processes for all significant activities and all types of risks. As such, they should largely summarize conclusions on the adequacy of risk-management processes for each individual function or activity evaluated.

In assigning these risk-management ratings, it is important to consider the quality of the risk-management process for the bank holding company overall, as well as for each individual function. At smaller bank holding companies engaged in traditional banking and nonbanking activities, relatively basic risk-management processes established for each significant activity, such as lending or asset/liability management, may be adequate to allow senior management to effectively manage the organization's overall risk profile. On the other hand, at larger bank holding companies that are typically engaged in more complex and widely diversified activities, effective risk-management systems must evaluate various functional management processes in combination so that aggregate risk exposures can be identified and monitored by senior management. Management information reports should typically be generated for the overall organization, as well as for individual functional areas. Some aggregate or specific company-wide limits may also be needed for the principal types of risks that are relevant to its activities.

A critical aspect of ensuring that a bank holding company's risk-management and control procedures remain adequate is the ongoing testing of the strength and integrity of these procedures and the extent to which they are understood and followed throughout the organization. When assigning a risk-management rating, examiners should assess the adequacy of the company's efforts to ensure that its procedures are being followed. The company's validation efforts must be conducted by those individuals who have proper levels of organizational independence and expertise, such as internal or external auditors, internal risk-management units, or managers or other professionals of the bank holding company who have no direct connection to the activities for which procedures are being assessed.

2124.0.2.6 Evaluation of Compliance with Laws and Regulations

Compliance with relevant laws and regulations should be assessed at every inspection. The steps taken to complete these assessments, however, will vary depending on the circumstances of the bank holding company being reviewed. When an organization has a history of satisfactory compliance with relevant laws and regulations or an effective compliance function, only a relatively limited degree of transaction testing need be conducted to assess compliance. For example, in evaluating compliance with the appraisal requirements of Regulation Y at a bank holding company with a formal compliance function, compliance may be ascertained by reviewing the scope and findings of internal and external audit activities, evaluating internal appraisal ordering and review processes, and sampling a selection of appraisals for compliance as part of the supervisory loan review process. On the other hand, at bank holding companies that have a less satisfactory compli-

3. U.S. branches and agencies of foreign banking organizations are assigned separate ROCA ratings for Risk management, Operational controls, Compliance, and Asset quality under guidance included in SR-95-22.

ance record or that lack a compliance function, more appraisals would naturally need to be tested to assess the overall compliance with the appraisal requirements of Regulation Y.

2124.0.2.7 Documentation of Supervisory Findings

The examiners' workpaper documentation of supervisory findings is necessary for Reserve Bank management to objectively verify the inspection work performed. Such documentation also provides a source of information on the condition and prospects of a bank holding company that is invaluable to the planning of future reviews. Most important, examiners' workpaper documentation provides support for the conclusions and recommendations detailed in the inspection report.

2124.0.2.8 Communication of Supervisory Findings

Effective and open communication between bank supervisory agencies and the board of directors and management of bank holding companies is essential to ensuring that the results of inspections are fully understood; the directorship and management are aware of any identified deficiencies; and, when necessary, they take appropriate corrective actions.

2124.0.3 INSPECTION OBJECTIVES

1. To ensure that the bank holding company has in place the processes necessary to identify, measure, monitor, and control its risk exposures for each of its activities or functions.
2. To improve inspection efficiencies by stressing increased in-office planning of inspections based on a risk- focused emphasis.
3. To identify and assess significant on- and off-balance-sheet activities and the greatest types and quantities of risk exposures and vulnerabilities to the bank holding company, tailoring the extent of transaction testing to the results of this review and other inspections' findings.
4. To review and assess the effectiveness and adequacy of documentation of the bank holding company's control and assessment activities and arrangements, including its internal control structure, and the qualifications of internal and external auditors and other independent personnel involved in the program.
5. To emphasize the preparation of a risk-focused scope memorandum, tailored to the size and complexity of the bank holding company under inspection.
6. To evaluate compliance with laws and regulations.
7. To adequately document and communicate inspection supervisory findings, recommendations, and conclusions.

2124.0.4 INSPECTION PROCEDURES

1. Identify the significant on- and off-balance-sheet activities of the bank holding company.

   a. Review prior inspection reports and workpapers, surveillance and monitoring reports generated by the Board and Reserve Bank staff, Uniform Bank Performance Reports and Bank Holding Company Performance Reports; regulatory reports (for example, bank call reports and FR Y-series and other FFIEC reports), and other relevant supervisory materials.

   b. Review strategic plans and budgets; internal management reports; board of directors information packages; correspondence and minutes, including minutes of meetings held between the bank holding company and the Reserve Bank; annual reports and quarterly SEC filings; press releases and published news stories; and stock analysts' reports.

2. Hold periodic discussions with management to gain insight into recently adopted strategies or plans to change activities or management processes.
3. Once the significant activities have been identified, determine and analyze the types (for example, credit, market, liquidity, operational, legal, and reputational) and quantities of risks to which those activities expose the bank holding company, placing greater inspection emphasis on the high-risk areas.
5. Develop an assessment of the processes that are used to identify, measure, monitor, and control the risks. Focus on the extent of board and senior management oversight; the adequacy of policies, procedures, limits, risk measurement, monitoring, and management information systems; and the existence of adequately documented internal audits and controls.
6. Prepare a scope memorandum tailored to the size and complexity of the bank holding company under inspection.
7. Conduct limited tests of the integrity of the risk-management system. Conduct more extensive transaction testing for those areas of a

bank holding company that are very significant in comparison to other areas, adjusting the level of transaction testing to the quality of internal risk-management processes. If initial inquiries or efforts to verify the system raise material doubts as to its effectiveness, place no reliance on the integrity of the bank holding company's risk-management system and conduct more extensive transaction testing.

8. Review the bank holding company's risk-assessment control activities, including an assessment of internal controls for particular functions and activities and for the bank holding company overall.

a. Evaluate the independence and competence of the personnel conducting control assessments and the effectiveness of the assessment program in covering the bank holding company's significant activities and risks.

b. Meet the independent external and internal auditors and other personnel responsible for evaluating internal controls and review the internal-control risk assessments, work plans, reports, workpapers, and related communications with the audit committee or board of directors.

9. Assess the adequacy of efforts to ensure that the current risk-management and control procedures are being followed.

10. Assess compliance with laws and regulations, adjusting the extent of transaction testing with the organization's history of satisfactory compliance.

11. Document all work performed and the supervisory findings. Include information on the condition and prospects of the bank holding company and its significant subsidiaries as well as the inspection's conclusions and recommendations.

2124.0.5 APPENDIX A—DEFINITIONS OF RISK TYPES EVALUATED AT INSPECTIONS

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a bank holding company's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices.
- *Liquidity risk* is the potential that a bank holding company will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as ''funding liquidity risk'') or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (''market liquidity risk'').
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- *Legal risk* arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a bank holding company.
- *Reputational risk* is the potential that negative publicity on a bank holding company's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

2124.01.1 INSPECTION APPROACH FOR RISK-FOCUSED SUPERVISION

The inspection approach for large, complex banking organizations (LCBOs) is a risk-focused process that relies on an understanding of the banking organization[1] (the institution), the performance of risk assessments, the development of a supervisory plan, and inspection procedures that are tailored to the risk profile. The process for a complex institution relies more heavily on a central point of contact (CPC), detailed risk assessments, and a supervisory plan before the on-site inspection. The risk-focused inspection also incorporates the U.S. operations of foreign banking organizations (FBOs), for which the Federal Reserve has overall supervisory authority. See SR-97-24, SR-99-15, and section 2124.04.

2124.01.1.1 Risk-Focused Supervisory Objectives

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

1. *To provide flexible and responsive supervision.* The supervisory process is designed to be dynamic and forward looking so that it responds to technological advances, product innovation, and new risk-management systems and techniques, as well as to changes in the condition of an individual financial institution and developments in the market.
2. *To foster consistency, coordination, and communication among the appropriate supervisors.* Seamless supervision, which reduces regulatory burden and duplication, is promoted. The supervisory process uses examiner resources effectively by using the institution's internal and external risk-assessment and -monitoring systems; making appropriate use of joint and alternating examinations and inspections; and tailoring supervisory activities to an institution's condition, risk profile, and unique characteristics.
3. *To promote safety and soundness.* The supervisory process effectively evaluates the safety and soundness of banking organizations, including the assessment of risk-management systems, financial condition, and compliance with laws and regulations.
4. *To provide a comprehensive assessment of the institution.* The supervisory process integrates specialty areas (for example, information technology systems, trust, capital markets, and consumer compliance) and functional risk assessments and reviews, in cooperation with interested supervisors, into a comprehensive assessment of the institution.

2124.01.1.2 Key Elements of the Risk-Focused Framework

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

1. *Designation of a central point of contact.* Large institutions typically have operations in several jurisdictions, multiple charters, and diverse product lines. Consequently, the program requires that a CPC be designated for each institution to facilitate coordination and communication among the principal bank and other regulatory authorities (for example, securities, insurance, and other nonbanking supervisory entities). Further, the program requires that each CPC and LCBO be assigned a dedicated supervisory team and staff with specialized skills, knowledge, and experience tailored to the unique profile of a particular institution.
2. *Review of functional activities.* Large institutions are generally structured along business lines or functions, and some activities are managed on a centralized basis. As a result, a single type of risk may cross several legal entities. Therefore, the supervisory program incorporates assessments along functional lines to evaluate risk exposure and its impact on safety and soundness. These functional reviews will be integrated into the risk assessments for specific legal entities and

1. For this section, the term "banking organization" refers to bank holding companies and their domestic and foreign banking and nonbank subsidiaries. It is used synonomously with the term "institutions." That term, however, has an even broader meaning since it may include other entities (for example, Edge Act corporations and foreign branches of state member banks). See subsection 2124.01.1.3.1

used to support the supervisory ratings for individual legal entities.[2]

3. *Focus on risk-management processes.* Large institutions generally have highly developed risk-management systems such as internal audit, loan review, and compliance. The supervisory program emphasizes each institution's responsibility to be the principal source for detecting and deterring abusive and unsound practices through adequate internal controls and operating procedures. The program incorporates an approach that focuses on and evaluates the institution's risk-management systems, processes, and core proficiencies for identifying, measuring, monitoring, and controlling key risks, including credit, market, and operational risks. Yet, the program retains transaction testing and supervisory rating systems such as CAMELS, BOPEC, and ROCA. This diagnostic perspective provides insight into how effectively an institution is managing its operations and how well it is positioned to meet future business challenges. The program places less emphasis on traditional "point-in-time" balance-sheet assessments.
4. *Tailoring of supervisory activities.* Large institutions are unique, but all possess the ability to quickly change their risk profiles. To deliver effective supervision, the program incorporates an approach that tailors supervisory activities to the risk profile of an institution. By concentrating on an institution's major risk areas, examiners can achieve a more relevant and penetrating understanding of the institution's condition.
5. *Review of internally and externally generated management information.* A review of internal management and board reports, internal and external audit reports, and publicly available information will further supplement existing supervisory processes. Banking organizations are also encouraged to continually review and enhance their public disclosures in order to promote transparency and to foster and support supervisory processes and effective market discipline.
6. *Emphasis on ongoing supervision.* Large institutions face a rapidly changing environment. The supervisory program thus emphasizes ongoing supervision, monitoring, and assessment through increased planning; no less than quarterly reassessment of the organization's profile; and continuous off-site monitoring. Ongoing supervision allows for timely adjustments to the supervisory strategy as conditions change within the institution, enhanced information sharing System-wide and on an interagency basis, and the use of information technology platforms that foster more effective collaboration and communication.
7. *Effective communication with management.* An effective program of regular and meaningful contacts with management is necessary to maintain a current understanding of the institution's risk profile and risk-management processes without imposing undue burden, interfering with legitimate management prerogatives, or compromising the objectivity of the supervisory process.

2124.01.1.3 Banking Organizations Covered by the Framework

For purposes of the risk-focused supervision framework, LCBOs generally have a functional management structure, a broad array of products, operations that span multiple supervisory jurisdictions, and consolidated assets of $1 billion or more.[3] These institutions may be state member banks, bank holding companies (including their nonbank and foreign subsidiaries), and branches and agencies of FBOs. The complex-institution process may also be appropriate for some organizations with consolidated assets less than $1 billion.

LBCOs comprise larger institutions that have particularly complex operations and dynamic risk profiles. They demand a heightened level of planning, coordination, and innovative techniques to implement an effective supervisory program. These organizations typically have significant on- and off-balance-sheet risk exposures, offer a broad range of products and services at the domestic and international levels, are subject to multiple supervisors in the United States and abroad, and participate extensively in large-value payment and settlement systems.

An important aspect of the LCBO program is the assessment and evaluation of banking practices across a group of institutions with similar

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

3. Large institutions are defined differently in other regulatory guidance regarding regulatory reports and examination mandates.

business lines, characteristics, and risk profiles. This "portfolio" approach to supervision will (1) support and enhance timely judgments about individual institutions, including the identification of possible "outliers"; (2) facilitate peer-group assessments; (3) provide an improved framework for discerning industry trends; (4) foster more consistent supervision of institutions with similar businesses and risk profiles; (5) contribute substantially to the maintenance of a highly informed and skilled supervisory staff; and (6) promote the development and sharing of the best supervisory practices within the Federal Reserve and the supervisory community more broadly.

2124.01.1.3.1 Foreign Institutions

U.S. supervisory authorities are host-country rather than home-country supervisors for most of the U.S. operations of FBOs; therefore, the supervisory focus and objectives are somewhat different for U.S. operations of FBOs and are addressed separately in the FBO supervision program. The desired result of a risk-focused examination process, however, should be the same. The framework encompasses the supervision and examination processes and procedures relevant to the U.S. operations of FBOs, to the extent that they are appropriate. Any significant remaining differences are incorporated in the FBO supervision program.

2124.01.1.3.2 Nonbank Subsidiaries of Domestic Institutions

Nonbank subsidiaries of large, complex domestic institutions are covered by the risk-focused supervision program. These include (1) nonbank subsidiaries of the parent bank holding company and those of the subsidiary state member banks; (2) the significant branch operations, primarily foreign branches, of state member banks; and (3) subsidiary foreign banks of the holding company. The level of supervisory activity to be conducted for nonbank subsidiaries and foreign branches and subsidiaries of domestic institutions should be based on their individual risk levels relative to the consolidated organization. The risk associated with significant nonbank subsidiaries or branches should be identified as part of the consolidated risk-assessment planning process, and the appropriate level of supervisory coverage (whether on-site or off-site) should be described in the supervisory plan for the organization. Risk-focused supervisory planning should incorporate the use of the workpaper, "Nonbank Subsidiary of a Bank Holding Company Risk-Assessment Questionnaire" (see appendix B). It should be used as a guide for (1) determining whether a nonbank subsidiary poses significant risk to the entire LCBO (parent bank holding company) and (2) determining whether an on-site supervisory inspection or examination of the entity is needed.[4] The supervisory plan for the organization should also include a review of the institution's processes to ensure compliance with sections 23A and 23B of the Federal Reserve Act and various other regulations and guidelines that govern transactions between the bank and nonbank affiliates.

2124.01.1.3.3 Edge Act Corporations

Under section 25A, paragraph 17, of the Federal Reserve Act, Edge Act corporations are subject to examination once a year and at such other times as deemed necessary by the Federal Reserve. While Reserve Banks must fulfill this legal mandate, there is flexibility in determining the extent of examination coverage. The scope of Edge Act corporation examinations should be determined through the risk-assessment process. Additionally, separate reports of examination are not required for Edge Act corporations, provided that all relevant findings are included in the consolidated report of examination of the parent bank.[5] This reporting procedure also applies to other nonbank subsidiaries of the bank or bank holding company.

2124.01.1.3.4 Specialty Areas Covered by the Framework

The Federal Reserve regularly conducts examinations, inspections, or reviews of several spe-

4. When this workpaper is used, a separate risk assessment of each nonbank subsidiary of the LCBO (for domestic bank holding companies) is not required. The separate risk-assessment requirements of SR-93-19 are thus partially superseded for LCBOs. Nonbank subsidiary risk assessments should be reflected in the entire consolidated organization's risk assessment.

5. A separate memorandum to the file should be prepared and retained that provides the date of examination of the Edge Act corporation, a summary of findings, the rating assigned, and a reference to the consolidated report of examination. This information should also be forwarded to Federal Reserve Board staff.

cialty areas. To achieve more efficient supervision and reduce the regulatory burden on institutions, steps have been taken to coordinate these reviews with the annual full-scope inspection of the consolidated organization. Under the risk-focused approach, the specialty areas should be included in the planning process in relation to the perceived level of risk to the consolidated organization or any state member bank subsidiary. Reviews of any specialty areas can be performed in conjunction with the annual full-scope inspection, or through targeted examinations or inspections, at any time during the supervisory cycle. The findings of all specialty reviews should be included in the inspection report for the consolidated organization.

2124.01.2 COORDINATION OF SUPERVISORY ACTIVITIES

Many large, complex institutions have interstate operations that expand with the continuation of mergers and acquisitions. In this environment, close cooperation with the other federal and state banking agencies is critical. To facilitate coordination between the Federal Reserve and other regulators, district Reserve Banks have been assigned roles and responsibilities that reflect their status as either the responsible Reserve Bank (RRB) with the CPC or the local Reserve Bank (LRB).

2124.01.2.1 Responsible Reserve Bank

The RRB facilitates the increased flexibility, planning, and coordination needed to effectively and efficiently supervise institutions with interstate operations. Considering the overriding objectives of seamless, risk-focused supervision, the RRB is responsible for designating the CPC and for ensuring that all aspects of the supervisory process are fully coordinated with LRBs and home-state supervisors.

To the extent possible, the RRB should rely on LRBs to provide the resources to conduct inspections/examinations of out-of-district subsidiaries of a parent organization, its state member bank subsidiaries, or the out-of-district offices of FBOs. Close coordination among the Reserve Banks and other appropriate regulators for each organization is critical to ensure a consistent, risk-focused approach to supervision. For further guidance, see sections 5000.0.7.5 or SR-93-48, section 5000.0.7.4 or SR-89-25, and SR-78-464.

2124.01.2.2 Local Reserve Banks

In general, LRBs are responsible for the direct supervision of institutions (including state member banks and bank holding companies) that are under Federal Reserve System supervision and are located in their district. The LRB provides the resources to the RRB to conduct the inspections of second-tier, domestic bank holding companies; nonbank subsidiaries; and branches and agencies of FBOs for top-tier holding companies located in the RRB's district. If the functional management of a banking organization is headquartered in its district, the LRB may also be called upon to conduct functional-business-line reviews. However, if a state member bank is owned by an out-of-district domestic holding company or if another Reserve Bank is responsible for the supervision of the overall U.S. operations of the FBO, the supervision of that entity should be coordinated by the RRB.

If the banking organization prefers to have supervisory contact with only one Reserve Bank, every effort should be made to centralize communication and coordination with the RRB for that organization. On the other hand, if the organization prefers more localized contact and communication, the coordination process can be adapted accordingly.

2124.01.2.3 Central Point of Contact

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

1. be knowledgeable, on an ongoing basis, about the institution's financial condition, management structure, strategic plan and direction, and overall operations;
2. remain up-to-date on the condition of the assigned institution and be knowledgeable regarding all supervisory activities, monitoring and surveillance information, applications issues, capital-markets activities, meetings with management, and enforcement issues, if applicable;

3. ensure that the objectives of seamless, risk-focused supervision are achieved for each institution and that the supervisory products (that is, an institutional overview, a risk matrix, a risk assessment, a supervisory plan, an inspection program, a scope memorandum, inspection modules, and an inspection report) are prepared in a timely manner;
4. ensure appropriate follow-up and tracking of supervisory concerns, corrective actions, or other matters which come to light through ongoing communications or surveillance; and
5. participate in the inspection/examination process, as needed, to (1) ensure consistency with the institution's supervisory plan and effective allocation of resources, including coordination of on-site efforts with specialty examination areas and other supervisors, as appropriate, and (2) to facilitate requests for information from the institution, wherever possible.

2124.01.2.4 Sharing of Information

To further promote seamless, risk-focused supervision, information related to a specific institution should be provided, as appropriate, to other interested supervisors. Sharing of these products with the institution, however, should be carefully evaluated on a case-by-case basis. The institutional overview, risk assessment, and supervisory plan may not be appropriate for release if they contain a hypothesis about an institution's risk rather than assessments verified through the inspection/examination process. On the other hand, it may be appropriate to share the inspection program with the institution in the interest of better coordination of activities.

2124.01.2.5 Coordination with Other Supervisors

Section 305 of the Riegle Community Development and Regulatory Improvement Act of 1994 directed the agencies to coordinate their examinations, to the extent possible, when they are jointly responsible for examination of various entities of a bank holding company.[6] To help achieve the desired degree of coordination, staffs of the agencies are expected, primarily at the regional level, to discuss examination plans and coordination issues. The institution involved is to be kept fully informed of the coordinated activities planned by the agencies, including a general timeframe in which each agency is expecting to conduct its examination activities.

2124.01.3 FUNCTIONAL APPROACH AND TARGETED INSPECTIONS

The framework for risk-focused supervision of large, complex institutions relies more heavily on a functional-business-line approach to supervising institutions, while effectively integrating the functional approach into the legal-entity assessment. Bank holding companies are increasingly being managed on a functional basis. Such functional management allows organizations to take advantage of the synergies among their components, to deliver better products to the market, and to provide higher returns to stockholders. Virtually all of the large bank holding companies operate as integrated units and are managed as such. For these companies, the risk-management systems are generally organized along business lines on a centralized basis. A key implication of this shift in management structure is that much of the information and insight gathered on inspections and examinations of individual legal entities can be fully understood only in the context of examination findings of other related legal entities or centralized functions. Developing that understanding means adapting some of the same functional-business-line approaches to supervision, including examination processes. Consequently, this risk-focused supervision framework incorporates risk assessments, that is, inspection and examination procedures that are organized by function.

The functional approach focuses principally on the key business activities (for example, lending, treasury, retail banking) rather than reviewing the legal entity and its balance sheet. This does not mean that the responsibility for a legal-entity assessment is ignored, nor should the Federal Reserve perform examinations of institutions for which other regulators have primary supervisory responsibility.[7] Rather, Fed-

6. In a December 1996 letter to the House Committee on Banking and Financial Services, the agencies outlined their cooperative efforts to meet the objectives of section 305.

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

eral Reserve examiners should integrate the findings of a functional review into the legal-entity assessment and coordinate closely with the primary regulator to gather sufficient information to form an assessment of the consolidated organization. Nonetheless, in some cases, effective supervision of the consolidated organization may require Federal Reserve examiners to perform process reviews and, possibly, transaction testing at all levels of the organization.

Functional-risk-focused supervision is to be achieved by the following actions:

1. Planning and conducting joint inspections and examinations with the primary regulator in areas of mutual interest, such as nondeposit investment products, interest-rate risk, liquidity, and mergers and acquisitions.
2. Leveraging off, or working from, the work performed by the primary regulator and the work performed by the institution's internal and external auditors by reviewing and using their workpapers and conclusions to avoid duplication of effort and to lessen the burden on the institution.
3. Reviewing inspection and examination reports and other communications to the institution that were issued by other supervisors.
4. Conducting a series of functional reviews or targeted inspections/examinations of business lines, relevant risk areas, or areas of significant supervisory concern during the supervisory cycle.[8] Functional reviews and targeted inspections/examinations are increasingly necessary to evaluate the relevant risk exposure of a large, complex institution and the effectiveness of related risk-management systems.

The relevant findings of functional reviews or targeted inspections and examinations should be handled as outlined below.

1. *Incorporated into the annual full-scope inspection.* In this context, a full-scope inspection involves the analysis of data sufficient to determine the safety and soundness of the institution and to assign supervisory ratings. The inspection/examination procedures required to arrive at those determinations do not necessarily have to be performed at the time of the annual inspection, but can be a product of the collective activities performed throughout the supervisory cycle. However, inspection procedures should contain follow-up on deficiencies noted in functional reviews or targeted inspections and examinations.
2. *Conveyed to the institution's management during a close-out or exit meeting with the relevant area's line management.* The need to communicate the findings to senior management or the board of directors is left to the judgment of Reserve Bank management based on the significance of the findings.
3. *Communicated in a formal written report to the institution's management or board of directors when significant weaknesses are detected or when the findings result in a downgrade of any rating component.* Otherwise, the vehicle for communicating the results is left to the judgment of the Reserve Bank's management and may either be a formal report or a supervisory letter.[9]

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

2124.01.4 OVERVIEW OF THE PROCESS AND PRODUCTS

The risk-focused methodology for the supervi-

8. A supervisory cycle is the period of time from the close of one annual examination to the close of the following annual examination.

9. As discussed in SR-92-31, it is currently Federal Reserve System practice to update BOPEC ratings between inspections to keep them current and to ensure that they reflect the latest information on the institution's financial condition. For state member banks, current policy dictates that Reserve Banks refrain from revising CAMELS ratings based on off-site analysis in view of the emphasis being placed on the CAMELS ratings for implementing risk-based insurance assessments and other supervisory initiatives. In accordance with SR-96-26 (see section 5010.4), Reserve Banks should notify the institution's management whenever the rating is changed as a result of off-site analysis.

sion program for large, complex institutions reflects a continuous and dynamic process. As table 1 indicates, the methodology consists of six key steps, each of which uses certain written products to facilitate communication and coordination.

Table 1—Steps and Products Involved in the Risk-Focused Supervision Process

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

* For examples of products 1 through 8, see the appendixes D through K of the Federal Reserve's handbook, ''Framework for Risk-Focused Supervision of Large, Complex Institutions'' referred to in SR-97-24. See also appendix B, the bank holding company nonbank subsidiary risk-assessment questionnaire, discussed in section 2124.01.1.3.2.

With the exception of the entry letter, the written products associated with steps one through four are designed to sharpen the supervisory focus on those business activities of an institution that pose the greatest risk, as well as to assess the adequacy of the institution's risk-management systems to identify, measure, monitor, and control risks. The products should be revised as new information is received from such sources as the current inspection, recent targeted inspections and examinations, and periodic reviews of regulatory reports.

The focus of the products should be on fully achieving a risk-focused, seamless, and coordinated supervisory process. The content and format of the products are flexible and should be adapted to correspond to the supervisory practices of the agencies involved and to the structure and complexity of the institution.

2124.01.5 UNDERSTANDING THE INSTITUTION

The starting point for risk-focused supervision is developing an understanding of the institution. This step is critical to tailoring the supervision program to meet the characteristics of the organization and to adjusting that program on an ongoing basis as circumstances change. It is also essential to clearly understand the Federal Reserve's supervisory role in relation to an institution and its affiliates. For example, the Federal Reserve's role pertaining to an FBO will vary depending on whether the Federal Reserve is the home- or host-country supervisor for the particular legal entity. Thus, planning and monitoring are key components.

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

2124.01.5.1 Sources of Information

Information generated by the Federal Reserve, other supervisors, the institution, and public organizations may assist the CPC in forming and maintaining an ongoing understanding of the institution's risk profile and current condition. For example, the Federal Reserve maintains a significant amount of financial and structure information in various automated databases. In addition, prior inspection and examination reports are excellent sources of information regarding previously identified problems.

Each Reserve Bank has various surveillance reports that identify outliers when an institution is compared to its peer group. The Bank Holding Company Performance Report and Uniform Bank Performance Report may identify significant deviations in performance relative to the institutions' peer groups, currently and between the inspections and examinations of those institutions. For branches and agencies, state mem-

ber banks, and domestic bank holding companies that are part of FBOs, the strength-of-support assessment (SOSA) rating and relevant credit assessments from major rating agencies provide information that needs to be considered in developing an appropriate supervisory strategy. For FBOs, the Federal Reserve has developed automated systems that provide information on foreign financial systems, foreign accounting standards, and the financial performance of FBOs with U.S. operations.

Leveraging off the work, knowledge, and conclusions of other supervisors is of key importance to understanding a large, complex organization. Ongoing contact and the exchange of information with other supervisors who have responsibilities for a given institution may provide insight into the institution that cannot be obtained from other sources. Additional information can be obtained from examination reports issued by other supervisors and their databases, for example, the OCC's Supervisory Monitoring System (SMS) and the FDIC's Bank Information Tracking System (BITS).

Using information generated by the institution's management information system improves the supervisory process. It provides an efficient way to reduce on-site time, identify emerging trends, and remain informed about the activities of the institution and financial markets. Information that may be periodically reviewed by the contact includes the size and composition of intraday balance sheets, internal risk-ratings of loans, internal limits and current risk measures regarding trading activities, and internal limits and measures covering the institution's interest-rate and market risk. Additionally, functional-organization charts reflecting the major lines of business across legal entities, changes to the organization's strategic plan, and information provided to the board of directors and management committees should be reviewed.

The CPC should also hold periodic discussions with the institution's management to cover, among other topics, credit-market conditions, new products, divestitures, mergers and acquisitions, and the results of any recently completed internal and external audits. When other agencies have supervisory responsibilities for the organization, joint meetings should be considered.

Publicly available information may provide additional insight into an institution's condition. This may be particularly valuable in assessing an organization's ability to raise capital. Public sources of information include SEC reports, press releases, and analyses by private rating agencies and securities dealers and underwriters.

2124.01.5.2 Preparation of the Institutional Overview

The institutional overview should provide an executive summary that communicates, in one concise document, information demonstrating an understanding of the institution's present condition and its current and prospective risk profiles. The overview should also highlight key issues and past supervisory findings. General types of information that may be valuable to present in the overview are listed below.[10]

1. a brief description of the organizational structure (with comments on the legal and business units) and changes through merger, acquisition, divestitures, consolidation, or charter conversion since the prior review
2. a summary of the organization's business strategies, key business lines, product mix, marketing emphasis, growth areas, acquisition or divestiture plans, and new products introduced since the prior review
3. key issues for the organization, either from external or internal factors (for example, difficulties in keeping pace with competition or poorly performing business lines)
4. an overview of management, commenting on the level of board oversight, leadership strengths or weaknesses, policy formulation, and the adequacy of management information systems (Comments should include anticipated changes in key management, unusual turnover in line management, and management-succession plans. Key executives and the extent of their participation in strategic planning, policy formulation, and risk management may also be described.)
5. a brief analysis of the consolidated financial condition and trends, including earnings, invested capital, and return on investment by business line
6. a description of the future prospects of the organization, expectations or strategic forecasts for key performance areas, and budget projections

10. This list is provided in the context of institutions for which the Federal Reserve is the home-country supervisor. In the case of an FBO, the analysis should begin with the SOSA rating and the Summary of Condition of its U.S. operations. See SR-95-22 and also sections 2124.0.2.5 and 2127.0.

7. descriptions of internal and external audit, including the nature of any special work performed by external auditors during the period under review
8. a summary of supervisory activity performed since the last review, including safety-and-soundness inspections, examinations, and targeted or specialty inspections/examinations; supervisory actions and the institution's degree of compliance; and applications approved or in process
9. considerations for conducting future inspections, including the institution's preference for the coordination of specialty inspections/examinations and combined inspection and examination reports, as well as logistical and timing considerations, including conversion activities, space planning, and management availability

2124.01.6 ASSESSING THE INSTITUTION'S RISKS

In order to focus supervisory activities on the areas of greatest risk to an institution, the CPC or designated staff personnel should perform a risk assessment. The risk assessment highlights both the strengths and vulnerabilities of an institution and provides a foundation for determining the supervisory activities to be conducted. Further, the assessment should apply to the entire spectrum of risks facing an institution, including the following risks:

1. *credit risk,* which arises from the potential that a borrower or counterparty will fail to perform on an obligation
2. *market risk,* which is the risk to an institution's financial condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices
3. *liquidity risk,* which is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding-liquidity risk") or because it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as "market-liquidity risk")
4. *operational risk,* which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses
5. *legal risk,* which arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization
6. *reputational risk,* which is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions

An institution's business activities present various combinations and concentrations of the above risks depending on the nature and scope of the particular activity. When conducting the risk assessment, consideration must be given to the institution's overall risk environment, the reliability of its internal risk management, the adequacy of its information technology systems, and the risks associated with each of its significant business activities. The preparation of the risk matrix provides a structured approach to assessing an institution's risks and is the basis for preparing the narrative risk assessment. See section 4070.1 and SR-95-51 for additional guidance on the evaluation of an institution's risk management.

2124.01.6.1 Assessment of the Overall Risk Environment

The starting point in the risk-assessment process is an evaluation of the institution's risk tolerance and of management's perception of the organization's strengths and weaknesses. Such an evaluation should entail discussions with management and a review of supporting documents, strategic plans, and policy statements. Management, in general, is expected to have a clear understanding of the institution's markets; the general banking, business, and economic environment; and how these factors affect the institution (in other words, their effect on the institution's use of technology, products, and delivery channels).

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

risk appetite determined by its board of directors.

2124.01.6.1.1 Internal-Risk-Management Evaluation

In assessing the overall risk environment, the CPC should make a preliminary evaluation of the institution's internal risk management. That includes an assessment of the adequacy of the institution's internal audit, loan-review, and compliance functions. External audits also provide important information regarding the risk profile and condition of the institution and may be used in the risk assessment. In completing this evaluation, Reserve Banks should consider holding meetings with the external auditor and senior management who are responsible for internal audit, loan review, and compliance, as well as with other key risk managers. As appropriate, the meetings should be held jointly with a representative from other supervisory agencies that have an interest in the institution.

In addition, the CPC or designated staff personnel should consider reviewing risk assessments developed by the internal audit department for significant lines of business, and then compare their results with the supervisory risk assessment. Further, the contact should consider evaluating management's ability to aggregate risks on a global basis. Examiners can use this preliminary evaluation to determine how much they can rely on the institution's internal risk management when developing their scope of inspection and examination activities.

2124.01.6.1.2 Adequacy of Information Technology Systems

Effective risk monitoring requires institutions to identify and measure all material risk exposures. Consequently, risk-monitoring activities must be supported by management information systems (MIS) that provide senior managers and directors with timely and reliable reports on the financial condition, operating performance, and risk exposure of the consolidated organization. Such systems must also provide managers engaged in the day-to-day management of the organization's activities with regular and sufficiently detailed reports for their areas of responsibility. Moreover, in most large, complex institutions, MIS not only provides reporting systems, but also supports a broad range of business decisions through sophisticated risk-management and decision tools, such as credit scoring and asset/liability models and automated trading systems. Accordingly, the institution's risk assessment must consider the adequacy of information technology systems.

Institutions need to determine which business unit or units are responsible for the development and operation of the information technology system. Traditionally, such systems were largely centered on mainframe computers. However, the development of increasingly powerful and inexpensive personal computers and sophisticated network communication capabilities has given institutions more timely access to a greater volume of information that supports a broader range of business decisions—moving some transaction processing out of the mainframe environment. Consequently, many large institutions are transferring responsibility for development and operation of the hardware (generally, a local area or wide area network) and the related operating systems and applications from a centralized, mainframe function to individual business units. Many of these institutions are also integrating the information technology audit function with the general internal-audit function.

Once it has been determined which business units are responsible for information technology, a fuller understanding of the risk profile of specific functions and of the consolidated organization can be gained through close coordination between information systems specialists and safety-and-soundness examiners. Since business managers must have MIS reports that are sufficient and appropriate for identifying risks, examiners must work with specialists to assess the adequacy of the information technology system and the extent to which it can be relied upon. Evaluating the integrity of the information contained in reports for business managers requires an understanding of the information flows and the control environment for the operation. Knowledge of the business application is essential to determine whether the information flows are complete, accurate, and appropriate in a particular MIS. In addition, such a determination requires an assessment of the extent to which the institution's internal audit function has procedures in place for reviewing and testing the effectiveness of the processes and internal controls related to information technology systems.

2124.01.6.2 Preparation of the Risk Matrix

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

2124.01.6.2.1 Identification of Significant Activities

Activities and their significance can be identified by reviewing information from the institution, the Reserve Bank, or other supervisors. Information generated by the institution may include the balance sheet, off-balance-sheet reports, the income statement, management accounting reports, or any other report that is prepared for the institution's board of directors and senior management to monitor performance. A detailed income statement is particularly informative because it reflects significant activities and their relative importance to the institution's revenue and net income. The income statement also yields information regarding the relationship between the return on individual assets and the inherent risk associated with these assets, providing an important indicator of the institution's overall risk appetite.

Off-site surveillance information is another source of information that can be used to identify new or expanding business activities. For example, substantial growth in the loan portfolio may indicate that the institution has introduced a new lending activity.

In addition to financial factors, information on strategic plans, new products, and possible management changes needs to be considered. The competitive climate in which the institution operates is very important and should be assessed in the identification of significant activities. Industry segmentation and the position the institution occupies within its markets should also be considered.

2124.01.6.2.2 Type and Level of Inherent Risk of Significant Activities

After the significant activities are identified, the type and level of risk inherent in those activities should be determined. Types of risk may be categorized according to section 4070.1.2 and SR-95-51, or by using categories defined either by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, the examiner should determine if all relevant types of risk are appropriately captured. If risks are appropriately captured by the institution, the examiner should use the categories identified by the institution.

Table 2 illustrates risk types as defined by the Federal Reserve and the OCC.[11] This table is designed to show the relationship between the respective agencies' risk categories.

Table 2—Types of Risk

Federal Reserve	*OCC*
Credit	Credit
Market	Price Interest rate Foreign exchange
Liquidity	Liquidity
Reputational	Reputation
Operational	Transaction
Legal	Compliance
	Strategic*

* Elements of strategic risk are reflected in each of the risk categories as defined by the Federal Reserve.

For the identified functions or activities, the inherent risk involved in that activity should be described as high, moderate, or low for each type of risk associated with it. For example, it may be determined that a portfolio of commercial loans in a particular institution has high credit risk, moderate market risk, moderate liquidity risk, low operational risk, low legal risk, and low reputational risk. The following definitions apply:

1. *High inherent risk* exists when (1) the activity is significant or positions are large in

11. The FDIC is considering its definition of risk types.

relation to the institution's resources or to its peer group, (2) there are a substantial number of transactions, or (3) the nature of the activity is inherently more complex than normal. Thus, the activity could potentially result in a significant and harmful loss to the organization.

2. *Moderate inherent risk* exists when (1) positions are average in relation to the institution's resources or to its peer group, (2) the volume of transactions is average, and (3) the activity is more typical or traditional. Thus, while the activity could potentially result in a loss to the organization, the loss could be absorbed by the organization in the normal course of business.
3. *Low inherent risk* exists when the volume, size, or nature of the activity is such that even if the internal controls have weaknesses, the risk of loss is remote or, if a loss were to occur, it would have little negative impact on the institution's overall financial condition.

It is important to remember that this assessment of risk is made without considering management processes and controls. Those factors are considered in evaluating the adequacy of the institution's risk-management systems.

2124.01.6.2.3 Risk-Management-Adequacy Assessment for Significant Activities

When assessing the adequacy of an institution's risk-management systems for identified functions or activities, the CPC or designated staff personnel should place primary consideration on findings related to the following key elements of a sound risk-management system:

1. active board and senior management oversight
2. adequate policies, procedures, and limits
3. adequate risk-management, -monitoring, and management information systems
4. comprehensive internal controls

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

1. *Strong risk management* indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function. The board and management participate in managing risk and ensure that appropriate policies and limits exist, which the board understands, reviews, and approves. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide the necessary information and analyses to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.
2. *Acceptable risk management* indicates that the institution's risk-management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.
3. *Weak risk management* indicates risk-management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

The definitions above apply to the risk management of individual functions or activities. They parallel the definitions set forth in section

4070.1.2 (SR-95-51) that examiners are to use to rate an institution's overall risk management. However, unlike the overall risk-management rating, the assessment of the adequacy of risk-management systems incorporated into the risk matrix is to be used primarily for planning supervisory activities. In addition, because the risk matrix is prepared during the planning process, it generally would not be appropriate to make fine gradations in the strength of risk-management systems on a function-by-function basis. In particular, for purposes of rating an institution's overall risk management, section 4070.1.2 (SR-95-51) makes distinctions in degrees of weakness—fair, marginal, and unsatisfactory—that generally cannot be made appropriately on a function-by-function basis, as called for when preparing the risk matrix. After appropriate inspection and examination procedures are performed, the assessment of the institution's risk management that was prepared for the risk matrix may be a starting point for assigning an overall risk-management rating for the institution.

2124.01.6.2.4 Composite-Risk Assessment of Significant Activities

The composite risk for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk-management systems for that activity. For example, commercial real estate loans usually will be determined to be inherently high risk. However, the probability and the magnitude of possible loss may be reduced by having very conservative underwriting standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with commercial real estate loans may be moderate. Table 3 provides guidance on assessing the composite risk of an activity by balancing the observed quantity and degree of risk with the perceived strength of related management processes and internal controls.

To facilitate consistency in the preparation of the risk matrix, general definitions of the composite level of risk for significant activities are provided below.

Table 3—Composite Risk for Significant Activities

Risk-Management Systems	*Inherent Risk of the Activity*		
	Low	*Moderate*	*High*
	Composite-Risk Assessment		
Weak	Low or Moderate	Moderate or High	High
Acceptable	Low	Moderate	High
Strong	Low	Low or Moderate	Moderate or High

1. A *high composite risk* generally would be assigned to an activity when the risk-management system does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a financial loss that would have a significant negative impact on the organization's overall condition—in some cases, even where the systems are considered strong. For an activity with moderate inherent risk, a risk-management system that has significant weaknesses could result in a high composite-risk assessment because management appears to have an insufficient understanding of the risk and an uncertain capacity to anticipate and respond to changing conditions.
2. A *moderate composite risk* generally would be assigned to an activity with moderate inherent risk where the risk-management systems appropriately mitigate the risk. For an activity with a low inherent risk, significant weaknesses in the risk-management system may result in a moderate composite-risk assessment. On the other hand, a strong risk-management system may reduce the risks of an inherently high-risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the organization.
3. A *low composite risk* generally would be assigned to an activity that has low inherent risks. An activity with moderate inherent risk may be assessed a low composite risk where internal controls and risk-management systems are strong and effectively mitigate much of the risk.

2124.01.6.2.5 Overall-Composite-Risk Assessment

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

2124.01.6.2.6 Preparation of the Risk Assessment

A written risk assessment should be prepared to serve as an internal supervisory planning tool and to facilitate communication with other supervisors. A sample risk assessment is provided below. The goal is to develop a document that presents a comprehensive, risk-focused view of the institution, which delineates the areas of supervisory concern and is a platform for developing the supervisory plan.

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

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

The CPC should attempt to identify and report the cause of unfavorable trends, as well as their symptoms. Also, it is very important that the risk assessment reflect a thorough, detailed analysis that supports the conclusions made about the institution's risk profile.

2124.01.7 PLANNING AND SCHEDULING SUPERVISORY ACTIVITIES

The supervisory plan represents a bridge between the institution's risk assessment, which identifies significant risks and supervisory concerns, and the supervisory activities to be conducted. In developing the supervisory plan and inspection and examination schedules, the CPC should minimize disruption to the institution and, whenever possible, avoid duplicative inspection and examination efforts and requests for information from other supervisors.[12]

The institution's organizational structure and complexity represent significant considerations in planning the specific supervisory activities to be conducted. Additionally, interstate banking and branching activities have implications for planning on-site and off-site reviews. The scope and location of on-site work for interstate banking operations will depend on the significance and risk profile of local operations, the location of the supervised entity's major functions, and the degree of its centralization. Consistent with the Federal Reserve practice of not examining each branch of an intrastate branching network, the bulk of safety-and-soundness examinations for branches of an interstate bank would likely be conducted at the head office or regional offices, supplemented by periodic reviews of branch operations and internal controls. The supervisory plan should reflect the need to coordinate these reviews of branch operations with other supervisors.

12. See section 5000.0.8.3 and SR-93-30 and its attachments for guidance on examination coordination of holding company inspections with subsidiary bank and thrift examinations, and SR-95-22 regarding coordination with other agencies as part of the FBO supervision program.

2124.01.7.1 Preparation of the Supervisory Plan

A comprehensive supervisory plan[13] should be developed annually and updated as appropriate for the consolidated organization. The plan should demonstrate the supervisory concerns identified through the risk-assessment process and how the deficiencies noted in the previous inspection or examination are being or will be addressed. To the extent that the institution's risk-management systems are adequate, the level of supervisory activity may be adjusted. The plan should generally address the following areas:

1. All supervisory activities to be conducted, the scope of those activities (full or targeted), the objectives of those activities (for example, review of specific business lines, products, support functions, legal entities), and specific concerns regarding those activities, if any. Consideration should be given to—
   a. prioritizing supervisory resources on areas of higher risk,
   b. pooling examiner resources to reduce burden and redundancies,
   c. maximizing the use of examiners located where the activity is being conducted,
   d. coordinating examinations of different disciplines,
   e. determining compliance with, or the potential for, supervisory action, and
   f. balancing mandated requirements with the objectives of the plan.
2. General logistical information (for example, timetable of supervisory activities, participants, and expected resource requirements).
3. The extent to which internal and external audit, internal loan review, compliance, and other risk-management systems will be tested and relied upon.

The planning horizon to be covered by the plan is generally 18 months for domestic institutions.[14] The overall supervisory objectives and basic framework need to be outlined by midyear to facilitate preliminary discussions with other supervisors and to coincide with planning for the Federal Reserve's scheduling conferences. The plan should be finalized by the end of the year, for execution in the following year.

2124.01.7.2 Preparation of the Inspection/Examination Program

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

1. a schedule of activities, the duration of time, and resource estimates for planned projects
2. an identification of the agencies conducting and participating in the supervisory activity (when conducted jointly with other agencies, indicate the lead agency and the agency responsible for a particular activity) and the resources committed by all participants to the area(s) under review
3. the planned product for communicating findings (indicate whether it will be a formal report or supervisory memorandum)
4. the need for special examiner skills and the extent of participation by specialty disciplines

2124.01.8 DEFINING INSPECTION/EXAMINATION ACTIVITIES

The scope memorandum is an integral product in the risk-focused methodology. The memorandum identifies the key objectives of the on-site inspection or examination. The focus of on-site inspection or examination activities, as identified in the scope memorandum, should be oriented to a top-down approach that includes a

13. The supervisory plan is a high-level plan of supervisory activities to be conducted in monitoring the consolidated organization. More detailed procedures for a specific on-site inspection are appropriately addressed in a scope memorandum, which is discussed in section 2124.01.8.

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

review of the organization's internal risk-management systems and an appropriate level of transaction testing. The risk-focused methodology provides flexibility in the amount of on-site transaction testing. Although the focus of the inspection/examination is on the institution's processes, an appropriate level of transaction testing and asset review will be necessary to verify the integrity of internal systems. If internal systems are considered reliable, then transaction testing should be targeted to a level sufficient to validate that the systems are effective and accurate. Conversely, if internal management systems are deemed unreliable or ineffective, then transaction testing must be adjusted to increase the amount of coverage. The entry letter identifies the information necessary for the successful execution of the on-site inspection and/or examination procedures.

2124.01.8.1 Scope Memorandum

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

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

1. a statement of the objectives;
2. an overview of the activities and risks to be evaluated;
3. the level of reliance on internal risk-management systems and internal or external audit findings;
4. a description of the procedures that are to be performed, indicating any sampling process to be used and the level of transaction testing, when appropriate;
5. identification of the procedures that are expected to be performed off-site; and
6. a description of how the findings of targeted reviews, if any, will be used on the current inspection/examination.

2124.01.8.2 Entry Letter

Standardized entry inspection and examination letters[15] have been developed that are closely aligned with the risk-focused approach for large, complex institutions. They are designed to reduce the institutions' paperwork burden. The entry letters include a core section of required information that is pertinent to all large institutions, regardless of size or complexity. In addition to the core requests, supplementary questionnaires should be used as needed for the specialized areas such as asset securitization/sales, information systems, private banking, securities clearance/lending, trading activities, and transfer risk. The cover letters must be used (they can be modified), as they provide specific guidance to the inspected or examined institution.

The entry letters direct management to provide written responses to questions and to provide copies of specific documents requested, but only if the requested information is new or has changed since the previous examination or inspection. Examiners should not request management to provide them with copies of the institution's regulatory reports that are available within each Federal Reserve Bank or from other bank regulatory agencies, such as regulatory inspection and examination reports and various financial information (for example, annual reports or call reports). These reports should be gathered from internal sources during the preexamination planning process. Also, entry letters should not request information that is regularly provided to designated CPCs. The examiner-in-charge should always review anticipated information and document needs with the CPC for the inspected or examined institution before the mailing of any entry letter.

The entry letters should be used as a starting point, or template, in preparing for an examination or inspection. They should be tailored during the planning process to fit the specific character and profile of the institution to be inspected or examined and the scope of the

15. Such entry letters should be used for a (1) combined bank holding company inspection and lead state member bank examination, (2) bank holding company inspection (see appendix B), and (3) state member bank examination.

activities to be performed. Thus, the effective use of entry letters is highly dependent on the planning and scoping of a risk-focused inspection or examination.

The entry letters request internal management information reports for each of the key inspection/examination areas. Internal management reports should be used in all instances. If they do not provide sufficient information to inspect or examine the institution, then it would appear that management is not adequately informed—this may well be the first inspection or examination finding. As specific items are selected for inclusion in the entry letter, the following guidelines for items should be considered:

1. *Reflect risk-focused supervision objectives and the inspection/examination scope.* Items that are not needed to support selected inspection/examination procedures should not be requested.
2. *Facilitate efficiency in the inspection/examination process and lessen the burden on financial institutions.* Minimize the number of requested items and avoid, to the extent possible, duplicate requests for information already provided to other agencies.
3. *Limit, to the extent possible, requests for special management reports.*
4. *Eliminate items used for audit-type procedures.* Such procedures (for example, verifications) are generally performed only when there is a reason to suspect that significant problems exist.
5. *Distinguish information to be mailed to the examiner-in-charge for off-site inspection/examination procedures from information to be held at the institution for on-site procedures.* Information that is not easily reproduced should be reviewed on-site (for example, policies, corporate minutes, audit workpapers).
6. *Allow management sufficient lead time to prepare the requested information.*

2124.01.9 PERFORMING INSPECTION OR EXAMINATION PROCEDURES

Inspection or examination procedures should be tailored to the characteristics of each institution, keeping in mind its size, complexity, and risk profile. The procedures should focus on developing appropriate documentation to adequately assess management's ability to identify, measure, monitor, and control risks. Procedures should be completed to the degree necessary to determine whether the institution's management understands and adequately controls the levels and types of risks that are assumed. In terms of transaction testing, the volume of transactions tested should be adjusted according to management's ability to accurately identify problem and potential problem transactions and to measure, monitor, and control the institution's risk exposure. Likewise, the level of transaction testing for compliance with laws, regulations, and supervisory policy statements should take into account the effectiveness of management systems to monitor, evaluate, and ensure compliance.

Most full-scope inspections/examinations are expected to include the examiners' evaluation of 10 functional areas during the supervisory cycle. There may be a need to identify and include additional functional areas. To evaluate these functional areas, examiners must perform procedures tailored to fit (1) the risk assessment prepared for the institution and (2) the scope memorandum. These functional areas represent the primary business activities and functions of large, complex institutions, as well as common sources of significant risk to them. Further, consistent with the risk-focused approach, examiners are expected to evaluate other areas that are significant sources of risk to an institution or central to the assignment of CAMELS, BOPEC, and ROCA ratings. The identified functional areas include the following:

1. loan portfolio analysis (portfolio management, loan review, allowance for loan and lease losses)
2. Treasury activities (asset/liability management, interest-rate risk, parent company liquidity, funding, investments, deposits)
3. trading and capital-markets activities (foreign exchange, commodities, equities, and other interest-rate risk; credit risk; and liquidity risk)
4. audit and internal control review
5. final assessment of supervisory ratings (CAMELS, BOPEC, ROCA, or other)
6. information systems
7. fiduciary activities
8. private banking
9. retail-banking activities (new products and delivery systems)
10. payments system risk (wire transfers, reserves, settlement)

2124.01.10 REPORTING THE FINDINGS

It is important for examiners to document their overall conclusions after performing the inspection/examination procedures. Conclusions, as they relate to the functional area under review, should clearly communicate the examiner's assessment of the internal risk-management system, the financial condition, and compliance with laws and regulations.

Inspection and examination activities should be coordinated with the respective state and other federal banking authorities, with joint examinations performed and joint inspection and examination reports completed wherever practicable. The inspection and examination activities should be planned over the supervisory cycle, culminating with an annual, full-scope inspection/examination of the organization. As part of the FBO supervision program, individual examination findings are integrated into an assessment of the FBO's entire U.S. operations.

The results of a targeted, subsidiary, or specialty inspection or examination are usually reported to the institution's management in a separate report or supervisory letter. Therefore, the report for the annual full-scope inspection of the consolidated parent organization should include a summary of the relevant results of any preceding supervisory activity. When targeted or specialty inspections or examinations of affiliates are conducted concurrently with the annual full-scope inspection of the consolidated parent organization, the findings from the targeted or specialty examinations should be incorporated into the parent's inspection report in lieu of separate reports, unless the institution's management requests separate reports. For organizations where the lead bank is a state member bank, the annual full-scope examination report should be combined with the bank holding company inspection report, as appropriate. The bank holding company inspection report, or combined inspection/examination report, may also include other bank and nonbank subsidiary examinations, according to the organization's supervisory plan.

The contents of the report should clearly and concisely communicate to the institution's management or to the directorate any supervisory issues, problems, or concerns related to the institution, as well as disclose the assigned supervisory rating.[16] The report should also include appropriate comments regarding deficiencies noted in the institution's risk-management systems. Accordingly, the descriptions accompanying each component of the CAMELS rating system[17] should emphasize management's ability to identify, measure, monitor, and control risks. The rating assigned should reflect the adequacy of the institution's risk-management systems in light of the amount and types of risks that the institution has taken on.

16. See section 5010.4 and SR-96-26 for additional information.

17. See SR-96-38 for additional information on the revised CAMELS rating system.

2124.01.11 APPENDIX A—RISK-FOCUSED SUPERVISORY LETTERS WITH BHC SUPERVISION MANUAL SECTION NUMBERS

SR-Letter	*SR-Letter Title*	*BHCSM Section No.*
SR-99-23 (SUP)	Recent Trends in Bank Lending Standards for Commercial Loans	2010.2.2 2010.10
SR-99-18 (SUP)	Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles	4070.3
SR-99-15 (SUP)	Risk-Focused Supervision of Large, Complex Banking Organizations	2124.04
SR-99-6 (SUP)	Subprime Lending	2190.05
SR-99-3 (SUP)	Supervisory Guidance Regarding Counterparty-Credit-Risk Management	2126.3

SR-Letter	*SR-Letter Title*	*BHCSM Section No.*
SR-98-18 (SUP)	Lending Standards for Commercial Loans	2122.0
SR-98-12 (SUP)	FFIEC Policy Statement on Investment Securities and End-User Derivatives Activities	2126.1
SR-98-9 (SUP)	Assessment of Information Technology in the Risk-Focused Frameworks for the Supervision of Community Banks and Large, Complex Banking Organizations	2124.1
SR-97-35 (SUP)	Interagency Guidance on the Internal Audit Function and Its Outsourcing	2060.05
SR-97-24 (SUP)	Risk-Focused Framework for Supervision of Large, Complex Institutions	2124.01
SR-97-21 (SUP)	Risk Management and Capital Adequacy of Exposures Arising from Secondary-Market Credit Activities	2129.05
SR-96-38 (SUP)	Uniform Financial Institution Rating System (CAMELS—adding the "S" for risk management)	4020.9 4070.0.4 4080.0
SR-96-33 (SUP)	State/Federal Protocol and Nationwide Supervisory Agreement	
SR-96-29 (SUP)	Supervisory Program for Risk-Based Inspection of Top 50 Bank Holding Companies	
SR-96-27 (SUP)	Guidance on Addressing Internal Control Weaknesses in U.S. Branches and Agencies of Foreign Banking Organizations through Special Audit Procedures	
SR-96-26 (SUP)	Provisions of Individual Components of the Rating System	5010.4
SR-96-17 (GEN)	Supervisory Guidance for Credit Derivatives	2129.0
SR-96-14 (SUP)	Risk-Focused Safety-and-Soundness Examination and Inspection	2124.0
SR-96-13 (SUP)	Joint Policy Statement on Interest-Rate Risk	2127.0
SR-96-10 (SPE)	Risk-Focused Fiduciary Examinations	
SR-95-51 (SUP)	Rating the Adequacy of Risk Management and Internal Controls at State Member Banks and Bank Holding Companies	4070.1
SR-95-17 (SUP)	Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities	2126.0
SR-93-69 (FIS)	Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations	2125.0
SR-93-19 (FIS)	Supplemental Guidance for Inspection of Nonbank Subsidiaries of Bank Holding Companies	5000.0.4.4
SR-92-31 (FIS)	Administrative Procedures for Reporting Revised BOPEC Ratings	
SR-89-25 (FIS)	Multi-Tier Bank Holding Company Inspections	5000.0.7.5

2124.01.12 APPENDIX B—NONBANK SUBSIDIARY RISK-ASSESSMENT QUESTIONNAIRE

NONBANK SUBSIDIARY OF A BANK HOLDING COMPANY RISK-ASSESSMENT QUESTIONNAIRE

Name of subsidiary _____

Name of bank holding company _____

BHC Consolidated:
Tier 1 capital: $_____ Total operating revenue*: $_____

*Defined as the sum of total interest income and total noninterest income, before extraordinary items.

Subsidiary total assets: $_____ Subsidiary total operating revenue: $_____

Questions: *(Circle answer.)*

1. Are the subsidiary's total assets 10 percent or more of BHC consolidated tier 1 capital? Yes No

2. Is the subsidiary's total operating revenue 10 percent or more of BHC consolidated operating revenue? Yes No

3. Does the subsidiary issue debt to unaffiliated parties? Yes No

4. Does the subsidiary rely on affiliated banks for funding debt that is either greater than $10 million or 5 percent of BHC consolidated tier 1 capital? (See SR-93-19.) Yes No

5. Is the subsidiary involved in asset securitization? Yes No

6. Does the subsidiary generate assets and sell assets to affiliates? Yes No

7. Is the subsidiary a section 20 company? Yes No

8. Does the subsidiary provide derivative instruments for sale or as a service to unaffiliated parties? Yes No

9. Has the subsidiary had a significant impact on the BHC's condition or performance? Yes No

If any question is answered yes, then this subsidiary should be considered for on-site review. If an on-site review is not being conducted, state the reason below.

Prepared by: _____ Date: _____

2124.01.13 APPENDIX C—FEDERAL RESERVE BANK COVER LETTER AND BHC INSPECTION QUESTIONNAIRE

Federal Reserve Bank
of San Francisco

Division of Banking Supervision and Regulation
San Francisco, California 94120

D.F. Roe
Senior Vice President
DEF BanCorp
Greentree Boulevard
Anytown, U.S.A. 11111

Dear Mr. Roe:

In order to facilitate an inspection of DEF BanCorp on a fully consolidated basis, you are requested to instruct the appropriate staff to provide the information described in this questionnaire. Unless indicated otherwise, information is requested as of the financial statement date December 31, 20X2. You are asked to provide written responses to questions and copies of specific documents requested in this questionnaire only if the requested information is new or has changed since the previous inspection, which was conducted as of December 31, 20X1 (indicate no change where applicable). For each area covered by this questionnaire, please provide the most recent reports used by management to identify, measure, monitor, and control risk in the respective areas. Please note that examiners may make additional requests during the inspection.

Single copies of all submissions in response to the requests will be satisfactory unless otherwise indicated and should be delivered to the examiner-in-charge or designee. Any requests for clarification or definition of terms should also be directed to the examiner-in-charge.

In order to expedite the inspection, each completed schedule and other requested information should be submitted as soon as prepared and should not be accumulated for submission as a package. Please respond to every item in the questionnaire, indicating N/A if a question is not applicable.

Most of the requested data will not be needed until the commencement of the inspection, which is March 15, 20X3. However, certain information may be needed earlier. Such information and the date due will be discussed with you.

_____ _____

Federal Reserve examiner-in-charge Examiner's telephone number

FEDERAL RESERVE BANK
BANK HOLDING COMPANY INSPECTION QUESTIONNAIRE

Please provide the following:

Structure

1. The most recent organization chart—
   (a) for the holding company and its subsidiaries by legal entity, showing percentage of ownership if less than 100 percent; and
   (b) of management by legal entity and functional business lines, if different, indicating lines of authority and allocation of duties for all key business lines and support areas of the organization.
2. List new activities that the bank holding company or nonbank subsidiaries have engaged in since the previous inspection, either on- or off-balance-sheet, and identify the group responsible for the management of these activities. How has management identified and evaluated risk in relation to these new activities? Provide copies of any management reports regarding these products/activities. Please provide a copy of the company's risk policy statement regarding new activities.
3. The following on each new subsidiary formed or acquired since the prior inspection and changes, where applicable, on existing subsidiaries.
   (a) name
   (b) location
   (c) date acquired or formed
   (d) percentage of ownership
   (e) nature of business or business purpose
   (f) list of branch locations by city and state
   (g) balance sheet and income statement
   (h) off-balance-sheet, asset securitization, and derivatives activities and description of such
   (i) list of principal officers
   (j) management contact person
4. Since (date), has there been any change in or transfer of functions or responsibilities between the corporation and its subsidiaries and between subsidiaries and/or their affiliates? If so, describe fully.
5. Since (date), have there been any sales or other transfers of any assets among the corporation and its subsidiary banks, affiliates of the banks, and/or other subsidiaries? If so, describe fully and include details on loan participations purchased and sold.
6. Since (date), have any subsidiaries been deactivated, sold, liquidated, transferred, or disposed of in some other way? If so, identify the subsidiary, the reason for disposition, and the effective date of disposition.
7. Has the corporation planned or entered into any new agreements, written or oral, to acquire any additional entities? If so, give pertinent details, including name, location, type of business, and purchase terms.

Corporate Planning and Policy Information

8. The latest financial projections or business plan(s) for revenues, expenses, assets, liabilities, capital, and contingent liabilities for the current and next fiscal years. Please include details on the assumptions used in the preparation of the projections.
9. A copy of the strategic business plan with updates or revisions, if any.
10. If new or amended since the prior inspection, copies of policies for the following:
    (a) the level of supervision exercised over subsidiaries
    (b) loans and investments of subsidiaries
    (c) loan participations by and between subsidiaries
    (d) dividends and fees from subsidiaries
    (e) dividends paid to stockholders
    (f) budgeting and tax planning for subsidiaries
    (g) insider transactions
    (h) funds, asset-liability, and interest-rate risk management at the parent company and subsidiaries
    (i) risk identification, evaluation, and control (for example, any credit risks, market risks, liquidity risks, reputational risks, operational risks, and legal risks)
    (j) internal loan-review and -grading system
    (k) internal audit
    (*l*) any authorized outstanding commitments to the Federal Reserve
    (m) description of any routine tie-in arrangements that are used in providing or contracting for services

Corporate Financial Information

11. For the consolidated company, provide consolidating balance sheet and income statement, including schedules of eliminating entries.
12. Full details on unaffiliated borrowings of the consolidated organization. For debt issued since the prior inspection, please provide the prospectus for public-debt offerings and a summary of terms for private-debt placements.
13. A copy of the most current periodic financial package prepared for senior management and/or directors.

Subsidiary Information

14. Consolidating and consolidated balance sheets, including off-balance-sheet items, and income statements for each nonbank first-tier subsidiary.
15. Details of all capital injections made to subsidiaries or returns of capital from subsidiaries (excluding normal operating dividends) since the prior inspection. Also provide details on any advance to a subsidiary which has been reclassified as equity.
16. If subsidiary banks have made any extensions of credit to the bank holding company and/or other affiliates, give details.

17. Describe any services performed by the parent for any subsidiaries or any company in which it has a 5 percent or greater interest.

Parent Company

18. Details on intercompany payments either (1) from the parent company to affiliates or subsidiaries or (2) from subsidiaries or affiliates to the parent company. Segregate into dividends, interest, management or service fees, expense payments, or other transfers made since the prior inspection. If a payment is governed by an intercompany agreement, please provide a copy of the agreement. If not, please provide the basis of the payment made.
19. Internally generated cash-flow statement and liquidity schedule for the latest quarter ending. Make available supporting documentation. Provide access to the workpapers supporting the preparation of the Cash-Flow Schedule (schedule PI-A) from the Y-9LP report
20. Full details on new parent company's investments in or advances to subsidiaries, and extensions of credit to and borrowings from subsidiaries (including unused lines of credit) since the previous inspection.
21. Full details on the terms of any third-party borrowing and credit lines made available since the previous inspection.
22. If any entities (parent company and/or subsidiaries) maintain compensating balances with third parties, indicate restrictions, if any.
23. A copy of the contingency funding plan. If such a plan does not exist, please provide a description of what actions would be taken to meet disruptions in the corporation's short-term liability market.
24. Details on security and other investments held by type; par; book and market values; number of shares owned; interest rates; maturity dates; and convertibility features, where applicable. Include a copy of all investment authorization policies and delegations of authority pertaining thereto.
25. For equity investments or any lending activity, please provide a listing with comments on any significant items that may not be fully collectible and any other relevant factors.
26. A copy of the capital funding plan or planned changes in equity funding, a financial analysis of any changes in equity (including any stock redemptions), and any internal financial analysis used to evaluate capital adequacy.
27. Since the previous inspection, if the corporation has purchased or sold securities or other assets under an agreement to resell or repurchase, give details.
28. If the corporation has, for its own account, any incomplete purchases or sales of securities pending, give details.
29. If the parent corporation and/or any nonbank subsidiaries have loans outstanding that are secured by stock or any obligations of the corporation or any of its subsidiaries, give details.
30. Since the prior inspection, if the corporation, either for its own account or for others, has guaranteed the payment of any loan or other debt obligation or guaranteed the performance of any other undertaking, provide details.

Corporate-Debt-Markets Activities

31. The following information on commercial paper:

    (a) direct placements outstanding

(b) dealer placements outstanding

(c) monthly maturity schedules showing breakdown for direct and dealer placements

(d) a copy of a ‘‘no action’’ letter, if the SEC has issued one

32. Identify any subsidiary which sells commercial paper for its own use or for its parent.

33. If any commercial paper, stock, and/or convertible debt of the corporation or its subsidiaries is held by trust departments of subsidiary banks, provide details.

34. If there are any concentrations of commercial paper holdings in excess of 10 percent of the outstanding commercial paper by any individual or organization, provide details.

Corporate Tax Information

35. If the corporation files a consolidated tax return, on what basis does it determine the amount of taxes to be paid by subsidiaries? Provide a copy of the tax-sharing agreement with subsidiaries.

36. A schedule detailing the following information for (specify dates)—

(a) payments (estimated or otherwise) made by the corporate-tax-paying entity to the taxing authorities and the dates of such payments; and

(b) payments received by the tax-paying entity from other holding company subsidiaries (or the tax benefits paid to those subsidiaries) and transaction dates.

37. Provide details of any ongoing IRS audit.

Officers, Directors, and Shareholders

38. For senior officers of the corporation, indicate their title, responsibility, and position(s) held at subsidiary and/or other organizations.

39. List of directors of the corporation, including—

(a) number of shares owned directly and/or indirectly, and

(b) occupation or principal business affiliation.

40. A brief biography of each senior officer appointed and director elected since the prior inspection. Please include the person’s date of birth, business background, education, and affiliations with any outside organizations. For senior officers, indicate date of hire. For directors, indicate date of election to board.

41. List of board committees, their memberships, and frequency of meetings.

42. Make available board and committee minutes.

43. Details on fees paid to directors.

44. If the corporation has entered into any contracts or agreements to pay or provide additional sums or fringe benefits to any director, officer, or employee, provide cost and details.

45. Details on any stock option, incentive, bonus, or performance plans for officers and employees.

46. List of loans made by the parent company and/or nonbank subsidiaries to directors and executive officers (and their interests) of the parent company and/or subsidiaries. For the purpose of this request, a director’s or executive officer’s interest refers to a beneficial ownership, directly or indirectly, amounting to 25 percent or more and also to companies otherwise controlled by a director or officer.

47. List of investments of the parent and/or subsidiaries in stocks, bonds, or other obligations of

corporations in which directors and executive officers have a beneficial interest.

48. List of loans to any borrower that are secured by stocks, bonds, or other obligations of corporations in which directors and executive officers have a beneficial interest.

49. List of shareholders who own 5 percent or more of any class of voting stock and the percentage held.

50. List of loans made by the parent company and/or nonbank subsidiaries to shareholders who own 5 percent or more of the parent company's outstanding shares.

Asset Quality

51. A copy of the latest internal consolidated asset-quality tracking report with aggregate totals of internally criticized assets and off-balance-sheet items. Identify aggregate exposures by type, risk rating, and entity where the exposure is booked. Distinguish between direct and indirect extensions of credit.

52. Details on consolidated loans past due as to principal and/or interest, nonperforming loans and other real estate owned, and totals of such for each subsidiary.

53. A breakdown of the corporation's consolidated and major subsidiaries' loan-loss reserves (for example, the allowance for loan and lease losses), including portions earmarked for the commercial, consumer, and other segments, with a description of and supporting data for the methodology used in determining its adequacy.

Audit

(The following information should be requested only if the function resides within the parent company. If the function is performed at a nonmember lead bank subsidiary, then assess the audit function through discussions with the bank's primary regulator.)

54. A copy of the most recent engagement letters or equivalent information which describes the scope of external audit activities performed for the corporation and any of its nonbank subsidiaries. Make available a copy of the audit program.

55. An organization chart which shows the structure and staffing of the audit function.

56. The following information about the auditor and key assistants (if not provided at prior inspections):

    (a) present position and date assumed

    (b) date of employment

    (c) brief summary of education, experience at this institution, and prior work experience

57. Make available the audit timetable and audit program, workpapers, and procedures used in conducting audits of the parent company and all subsidiaries.

Miscellaneous

58. A summary schedule of fidelity bond and general liability insurance, listing all areas covered for loss/liability, and date of board approval.

59. Make available the corporation's latest pending litigation report describing any significant pending or potential litigation or investigations against the organization or any director, officer, or policy-making employee in their official capacity, with the following information:

(a) name(s) of plaintiff

(b) nature of claim and damages requested

(c) current status

(d) an opinion of the probable outcome, including an estimation of the organization's liability

The Federal Reserve's ongoing large, complex banking organization (LCBO) supervisory program is designed to recognize dramatic changes in the financial, technological, legal, and regulatory environment that necessitate a flexible supervisory framework. This includes the ongoing review and assessment of LCBO risk profiles and the continual adjustment of supervisory plans and programs for individual banking organizations (BOs). Environmental factors that have a significant impact on the nature of LCBO operations and the financial system include the following:

1. *Financial innovation and deregulation.* The range, volume, and complexity of traditional banking businesses have increased, and BOs have moved into nontraditional and potentially more complex financial activities and services, such as securitizations, securities underwriting and dealing, trading, derivatives, and other capital-markets activities.[1]
2. *Increasing competitive pressures.* The distinctions between financial products have blurred, and the competition in national and global markets between BOs, nonbank financial firms, and diversified financial-services conglomerates has intensified.
3. *Geographic expansion and globalization.* The continued expansion by BOs, both nationally and globally, and the integration of financial markets have increased the challenges associated with assessing and supervising the worldwide activities of U.S. BOs and the U.S. operations of foreign banking organizations.
4. *Revolution in information technology.* The dramatic changes in information and telecommunications technology have increased the speed, complexity, geographic scope, and volume of financial transactions, and have made possible new techniques for BOs to take on and manage risks.

These environmental factors have the potential for swift and dramatic changes in the risk profiles of LCBOs and can provide avenues for the more rapid transmission of financial shocks. Such developments in turn require supervisors to employ more continuous and risk-focused supervision processes. See SR-99-15, SR-97-24, and section 2124.01.

1. The term "banking organizations" refers to bank holding companies and their bank and nonbank subsidiaries.

2124.04.1 CONTINUED UNDERSTANDING OF AN LCBO AND ITS MAJOR RISKS

The process of maintaining a *current* understanding of an LCBO and its major risks relies heavily on gathering information from a wide variety of public and confidential sources, including supervisory reviews and evaluations and discussions with management and other supervisors. One of the primary objectives of this enhanced supervisory method is to generate a flow of meaningful information that continuously promotes a comprehensive understanding of the LCBO. This understanding should include its major business lines and strategies, the risks inherent in its business activities, and the quality and effectiveness of its risk-management systems. Maintaining an up-to-date understanding of an LCBO's risk profile reduces the time-consuming and burdensome discovery process associated with conducting on-site examinations. Similarly, this understanding can also facilitate timely and efficient processing of major regulatory applications, including acquisitions and mergers, and other requests from BOs. Publicly available information, internal management reports, discussions with management, regulatory reports, information from internal and external auditors, and information from other supervisors are examples of the sources that are used to develop and maintain a current understanding of the organization. It may be less burdensome for the BO if supervisors can access management reports electronically, so electronic access should be employed when and where feasible and appropriate.

It is important that the principal risk-focused supervisory tools and documents, including the overview, risk matrix, and risk assessment for the LCBO, remain current. Accordingly, the central point of contact (CPC) should regularly distill and incorporate significant new information into these documents *at least quarterly.* Factors such as emerging risks; new products; and significant changes in business strategy, management, condition, or ownership may warrant more frequent updates. In general, the more dynamic the LCBO's operations and risks, the more frequently the CPC should update the risk assessment, strategies, and plans.

2124.04.2 DESIGN AND EXECUTION OF A CURRENT SUPERVISORY PLAN

Effective risk-focused supervision requires the development and maintenance of a supervisory plan that is current and relevant to the organization's changing risk profile. In addition to addressing all key supervisory objectives, the supervisory plan should be individually tailored for each BO to reflect its particular organizational and operational structure, and, where appropriate, the activities of other principal or functional supervisors. The supervisory plan and attendant supervisory activities, including on-site examinations, inspections, and supervisory reviews, should be sufficiently robust to maintain an up-to-date and thorough understanding of the BO's operations and risks, as well as the quality of its risk-management systems.

Ongoing assessments of the LCBO's major risks (for example, credit, market, liquidity, operational, legal, and reputational risks) should be used to formulate, revise, and update the supervisory plan. The Federal Reserve's supervisory plan should endeavor to take into account (1) the nature and scope of major activities conducted by other regulators involved in the LCBO and (2) any actions necessary to address existing or emerging supervisory concerns, including follow-up on past supervisory issues. For BOs supervised by the Federal Reserve, a combination of full- and limited-scope examinations, inspections, targeted reviews, meetings with management, and analyses of public and supervisory information should be used to maintain an up-to-date risk assessment and to reduce unnecessary regulatory burden. The necessary level of transaction testing and the degree of reliance on sampling should be fully explained in the scope documents of the supervisory plan and should adequately address the types and level of risks in the organization's business lines. Instances in which efficiencies can be gained by relying on the work of other regulators, internal and external auditors, and the internal risk-management function should, where appropriate, be specified in the plan and incorporated in the supervisory program.

The CPC should review and revise the supervisory plan whenever necessary *(but in no case less frequently than quarterly)* to reflect any significant new information or emerging trends or risks. The supervisory plan and any revisions should be periodically discussed with representatives of the principal regulators of major affiliates to reconfirm agreement on the overall plan and to coordinate its implementation, when warranted.

2124.04.3 COMMUNICATION AND COORDINATION OF SUPERVISION IN DEVELOPING AND ADMINISTERING A SUPERVISORY PLAN

The communication process as described herein can serve as the basis for executing a comprehensive supervisory approach that capitalizes on the mandates and resources of the various supervisory authorities (for example, banking, securities, and insurance authorities), while minimizing possible duplication and burden on the BO. The objective is for supervisors to work cooperatively in developing supervisory plans and scope documents and, when possible and appropriate, to carry out important supervisory activities on a joint or coordinated basis. Coordination and communication among supervisors can reduce the burden on BOs and result in a more efficient deployment of supervisory resources.

An important element of the LCBO program is effective communication between the Federal Reserve and the BO's management throughout the supervision cycle. Communication with the LCBO can take various forms, including formal and informal meetings with management and the board of directors, and the issuance of periodic and annual supervisory reports, including examination/inspection reports, to the organization's management and board. The objective of these reports is to identify significant risks and summarize the Federal Reserve's view of the financial condition and effectiveness of the LCBO's risk-management processes.

As part of the LCBO program, the management of the BO should be encouraged to continue and, if warranted, strengthen communications with Reserve Bank management, CPCs, and the supervisory teams, particularly with respect to providing information to supervisors on a timely basis regarding material financial or operational issues or problems. BOs should also be encouraged to continuously review and enhance their public disclosures to promote transparency and foster effective market discipline. Also, if BOs promptly notify supervisors of emerging problems, they often can be resolved in a way that minimizes disruptions. Strong two-way communications and information flows between supervisors and the LCBO's senior management, including key business-line

and risk managers, are essential to the success of the LCBO program. In carrying out this program, the Federal Reserve will continue to attach the highest priority to information security and to protecting the integrity of sensitive, confidential supervisory and examination/inspection information.

The LCBO supervisory framework also requires that results and findings of supervisory activities conducted throughout the supervisory cycle be continually evaluated and reflected in the Federal Reserve's current understanding and assessment of the organization's risk profile. Reports of examination/inspection or letters to the LCBO's management and board of directors should routinely be prepared when examinations, inspections, and targeted reviews are completed. If necessary, the organization's supervisory ratings should be revised in a timely manner based on those findings.[2] Management and composite supervisory ratings should be adjusted appropriately if material weaknesses in risk-management systems or controls exist, even if these weaknesses have not yet affected the organization's reported financial results.

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

2124.04.3.1 Information Sharing and Coordination with Supervisory Authorities and External and Internal Auditors

Information sharing and coordination within the Federal Reserve and with supervisors of major affiliates are critical elements of the LCBO program and are essential to successful supervision of LCBOs. Most LCBOs, regardless of their business lines and functional management structure, operate through a variety of legal entities that may be under the jurisdiction of different licensing and supervisory authorities in the United States and abroad.

To maximize efficiency and reduce regulatory burden, the risk-assessment and supervisory-planning processes should use and leverage off, or benefit from, the efforts of other principal supervisors to the extent possible, consistent with achieving the Federal Reserve's key supervisory objectives. The Reserve Bank responsible for the supervision of the LCBO should have regular contacts with supervisors of important affiliates of the organization to discuss and coordinate matters of common interest, to develop supervisory plans, and, when and where appropriate, to coordinate the scheduling and conduct of examinations, inspections, and targeted reviews. Consistent with the supervisory needs and responsibilities of the Federal Reserve and the other supervisors, information may be exchanged as permitted by law, and in accordance with applicable rules and policies of the Board. In addition, meetings should be held at reasonable intervals with internal and external auditors to review audit plans, evaluate significant audit findings and other control assessments, and foster opportunities to leverage off the auditors' work. Building on the work of auditors, when and where appropriate, can enhance supervisory efficiency and reduce the regulatory burden on the LCBO.

2124.04.3.2 Enhanced Use of Information Technology

The Federal Reserve's supervisory approach for LCBOs continues to use enhanced information technology. Timely and user-friendly access to a full range of internal and third-party information, and mechanisms to foster collaboration among Federal Reserve staff and other supervisors are essential to effective risk-focused supervision for LCBOs. Effective and timely information flows, facilitated by the use of enhanced information technology, can provide a way for supervisors to "harvest" and share the core knowledge and experience gained through the conduct of supervisory activities and through ongoing contacts with BOs. Ready access to the

2. The supervisory ratings include the BOPEC, CAMELS, and an FBO's combined U.S. operations rating.

collective knowledge, insights, and current assessments of fellow supervisors, bank management, financial markets, and other relevant third parties can enhance the ability of supervisors to identify problems in a timely manner and formulate effective supervisory responses. To this end, the Federal Reserve System's information-sharing and information-technology strategies will continue to be aimed at broadening and strengthening the role of the CPCs, supervisory teams, and other System staff that are responsible for conducting and overseeing its supervisory programs, including the LCBO program.

2124.04.4 ORGANIZATION OF FEDERAL RESERVE SUPERVISORY TEAMS

A principal component of the supervisory framework is the assignment to each LCBO of a dedicated supervisory team, made up of individuals with specialized skills based on the organization's particular business lines and risk profile. This full-time, dedicated cadre will be supplemented, as necessary, by other specialized System staff, who will participate in examinations and targeted reviews.

In addition to designing and executing the supervisory strategy for an LCBO, the CPC has responsibility for managing the supervisory team. Important objectives in managing the supervision resources for a particular LCBO are to maximize institutional knowledge and minimize burden to the BO, while maintaining an objective, ongoing understanding of the BO's risk profile. The CPC serves as the Federal Reserve's primary day-to-day contact for a particular LCBO and has, together with other members of the Reserve Bank management team, primary responsibility for communicating with senior officials of the LCBO.

The supervisory team's major responsibilities are to maintain a high level of knowledge of the BO and to ensure that supervisory strategies and priorities are consistent with the identified risks and the LCBO's profile. The team should include supervisors with broad-based knowledge and experience in banking, as well as specialists whose technical skills and market knowledge bring depth and perspective to highly focused reviews of selected LCBO activities.

The Federal Reserve had adopted risk-focused supervision frameworks for community banks and large complex banking organizations, including foreign banking organizations. These frameworks incorporate a methodology to assess an organization's risks and business activities and to tailor supervisory activities to its risk profile. These frameworks aim to sharpen the focus of supervisory activities on areas that pose the greatest risk to the safety and soundness of banking organizations and on management processes to identify, measure, monitor, and control risks.[1]

The Federal Reserve recognizes that the use of information technology can greatly affect a banking organization's financial condition and operating performance.[2] With the increasing dependency of banking organizations on the use of information technology, the Federal Reserve expects an organization's management and board of directors to effectively manage the risks associated with information technology. Accordingly, examiners must consider the risks associated with information technology in their evaluations of an organization's significant business activities and assess the effectiveness of the risk-management process that the organization applies to information technology. See SR-98-09.

This section supplements further the guidance on the evaluation of banking organizations' risk-management processes. The primary objectives are to—

1. highlight the critical dependence of the financial services industry on information technology and its potential effect on safety and soundness,
2. reinforce the concept that the risk-focused supervisory process and related products (risk assessments, supervisory plans, and scope memoranda) for an organization must address the risks associated with its use of information technology,[3] and
3. provide a basic framework and a common vocabulary to evaluate the effectiveness of processes used to manage the risks associated with information technology.

2124.1.1 CHANGING ROLE OF INFORMATION TECHNOLOGY

As the automated processing of information has moved beyond centralized mainframe operations to encompass end-user computer and distributed processing systems, the use of information technology in general has expanded greatly. In the banking industry, information technology was once limited to automation of routine transactions and preparation of financial reports but is now used to automate all levels of a banking organization's operations and information processing. Some decision-making processes such as credit scoring and securities trading have been fully automated. New, complex financial products are possible largely because of valuation models that depend on technology. Moreover, technological advances in communications and connectivity have minimized geographic constraints within the industry.

While information technology enables banking organizations to carry out their activities more efficiently and effectively, information technology also can be a source of risk to the industry. The operational concerns associated with information processing, traditionally the domain of the "back office," have assumed critical importance during banking mergers and consolidations.

Banking organizations, recognizing the dependency of their operations and decision-making processes on information technology, have placed increased emphasis on the management of this important resource. In large banking organizations, the positions of the chief information officer and chief technology officer have become more visible in the top executive ranks of banking organizations. In addition, managers of activities that rely on end-user computing and distributed processing systems

1. The types of risk may be categorized according to those presented in the guidelines for rating risk management (that is, credit, market, liquidity, operational, legal, and reputational) or by categories defined by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, those categories may be used if all relevant types of risks are captured. See SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies."

2. Information technology refers to a business resource that is the combination of computers (hardware and software), telecommunications, and information.

3. The supervisory products are described in SR-97-24 for large complex institutions and SR-97-25 for community banks.

have been assigned more direct responsibility for the information technology used in conducting their business. As a result, the management of the risks associated with information technology must be evaluated for each significant business activity as well as for the overall organization.

Notwithstanding the move towards decentralized management of information technology, large centralized mainframe computer systems are still an integral part of the information technology on which many large banking organizations rely. This includes systems critical to the global payments system and to the transfer and custody of securities. Similarly, with the continued growth of outsourcing, many third-party information technology service centers also perform a vital role in the banking industry. Therefore, the review of the effectiveness and reliability of the critical mainframe systems and third-party processors will continue to be an important part of the Federal Reserve's supervisory activities.

2124.1.2 IMPLICATIONS FOR RISK-FOCUSED SUPERVISION

The risk-focused supervisory process is evolving and adapting to the changing role of information technology, with a greater emphasis being placed on an evaluation of information technology and an assessment of its effect on an organization's safety and soundness. Accordingly, examiners should explicitly consider information technology when developing their risk assessments and supervisory plans. It is expected that examiners will exercise appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization. Moreover, to determine the scope of supervisory activities close coordination is needed between general safety-and-soundness examiners and information technology specialists during the risk assessment and planning, as well as during the on-site phase of the examination or inspection. In general, examiners should take the following actions:

1. Develop a broad understanding of the organization's approach, strategy, and structure with regard to information technology. This requires a determination of the role and importance of information technology to the organization and any unique characteristics or issues.
2. Incorporate an analysis of information technology systems into risk assessments, supervisory plans, and scope memoranda. The analysis should include identification of critical information technology systems, related management responsibility, and the major technology components.[4] An organization's information technology systems should be considered in relation to the size, activities, and complexity of the organization, as well as the degree of reliance on these systems.
3. Assess the organization's critical systems, that is, those that support its major business activities, and the degree of reliance those activities have on information technology systems. The level of review should be sufficient to determine that the systems are delivering the services necessary for the organization to conduct its business safely and soundly.
4. Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with information technology for the overall organization and its major business activities.

2124.1.3 FRAMEWORK FOR EVALUATING INFORMATION TECHNOLOGY

In order to provide a common terminology and consistent approach for evaluating the adequacy of an organization's information technology, five information technology elements are introduced and defined below. These elements may be used to evaluate the information technology processes at the functional business level or for the organization as a whole. They may also be applied to a variety of information technology management structures: centralized, decentralized, or outsourced.[5]

Although deficiencies in information technology appear to be most directly related to operational risk, information technology also can affect the other business risks (credit, market, liquidity, legal, and reputational) depending on

4. These components include mainframe, local area network, and personal computers, as well as software applications.

5. When banking organizations outsource operations, they delegate a certain level of responsibility and authority to an outside party (depending on the contractual arrangements). However, ultimate accountability remains with the banking organization.

the specific circumstances. Examiners should view the information technology elements in an integrated manner with the overall business risks of the organization or business activity; a deficiency in any one of the elements could have a substantive adverse effect on the organization's or activity's business risks. Moreover, the elements below do not replace or independently add to the business risks described in SR-95-51. Rather, these elements should be assessed in relation to all business risks.

The elements are to be used as a flexible tool to facilitate consideration and discussion of the risks associated with information technology. Where an organization uses different terminology to describe information technology elements, examiners may use that terminology provided the organization adequately addresses all elements. Regardless of the terminology employed, examiners should focus on those systems and issues that are considered critical to the organization.

The five information technology elements are described below:

1. *Management processes*. Management processes[6] encompass planning, investment, development, execution, and staffing of information technology from a corporate-wide and business-specific perspective. Management processes over information technology are effective when they are adequately and appropriately aligned with, and supportive of, the organization's mission and business objectives. Management processes include strategic planning, management and reporting hierarchy, management succession, and a regular independent review function. Examiners should determine if the information technology strategy for the business activity or organization is consistent with the organization's mission and business objectives and whether the information technology function has effective management processes to execute that strategy.
2. *Architecture*. Architecture[7] refers to the underlying design of an automated information system and its individual components. The underlying design encompasses both physical and logical architecture, including operating environments, as well as the organization of data. The individual components refer to network communications, hardware, and software, which includes operating systems, communications software, database management systems, programming languages, and desktop software. Effective architecture meets current and long-term organizational objectives, addresses capacity requirements to ensure that systems allow users to easily enter data at both normal and peak processing times, and provides satisfactory solutions to problems that arise when information is stored and processed in two or more systems that cannot be connected electronically. In assessing the adequacy of information technology architecture, examiners should consider the hardware's capability to run the software, the compatibility and integration with other systems and sources of data, the ability to upgrade to higher levels of performance and capacity, and the adequacy of controls.
3. *Integrity.* Integrity refers to the reliability, accuracy, and completeness of information delivered to the end-user. An information technology system has an effective level of integrity when the resulting information flows are accurate and complete. Insufficient integrity in an organization's systems could adversely affect day-to-day reliability, processing performance, input and output accuracy, and the ease of use of critical information. Examiners should review and consider whether the organization relies upon information system audits or independent application reviews to ensure the integrity of its systems. To assess the integrity of an organization's systems, examiners should review the reliability, accuracy, and completeness of information delivered.
4. *Security.* Security refers to the safety afforded to information assets and their data processing environments, using both physical and logical controls to achieve a level of protection commensurate with the value of the assets. Information technology has effective security when controls prevent unauthorized access; modification; destruction; or disclosure of information assets during their creation, transmission, processing, maintenance, or storage. Examiners should ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
5. *Availability.* Availability refers to the delivery of information to end-users. Information technology has effective availability when

6. Also referred to as "organization" or "strategic."
7. Sometimes referred to as "infrastructure."

information is consistently delivered on a timely basis in support of business and decision-making processes. In assessing the adequacy of availability, examiners should consider the capability of information technology to provide information from either primary or secondary sources to the end-users, as well as the ability of back-up systems, presented in contingency plans, to mitigate business disruption. Contingency plans should set out a process for an organization to restore or replace its information-processing resources, reconstruct its information assets, and resume its business activity from disruption caused by human error or intervention, natural disaster, or infrastructure failure (including the loss of utilities and communication lines and operational failure of hardware, software, and network communications).

Appendix A provides a table with examples of situations where deficiencies in information technology elements potentially have a negative effect on the business risks of an organization. The table also provides possible actions that an organization could take in these situations to mitigate its risks. The examples in this table are representative and should not be viewed as an exhaustive list of the risks associated with information technology.

2124.1.4 ALIGNING EXAMINER STAFFING WITH THE TECHNOLOGY ENVIRONMENT

While mainframe computer systems are still an integral part of the information technology for large organizations, information technology processes have become embedded in the various business activities of a banking organization—particularly with the increased use of local area network and personal computers. In contrast, many community and regional banks continue to rely on third-party information technology service centers. Given this variability of information technology environments, the level of technical expertise needed for a particular examination or inspection will vary and should be identified during its planning phase. For example, a specialist in information technology or the particular business activity may be the most appropriate person to review information technology integrity, while general safety-and-soundness examiners may be better suited to review management processes related to information technology. Development of the overall supervisory approach for an organization requires continuous collaboration between general safety-and-soundness examiners and information technology specialists. Accordingly, a discussion of information technology should be integrated into the supervisory process and products. That is, examiners should consider and comment on the risks associated with information technology when developing an understanding of an organization, assessing an organization's risks, and preparing a scope memorandum.

2124.1.5 INSPECTION OBJECTIVES

1. To assess the risks associated with information technology when developing the scope of supervisory plans and activities.
2. To consider the various risks associated with information technology along with the risk evaluation of the banking organization's business activities.
3. To assess the effectiveness of the risk-management process that the banking organization applies to information technology.
4. To view the banking organization's information technology elements in an integrated manner along with the overall business risks of the banking organization or its business activity, and ascertain if there are any deficiencies therein.

2124.1.6 INSPECTION PROCEDURES

1. Develop a broad understanding of the organization's approach, strategy, and structure with regard to information technology.
2. Incorporate an analysis of information technology systems into risk assessments, supervisory plans, and scope memoranda.
3. Assess the banking organization's critical systems and the degree of reliance those activities have on information technology systems.
4. Determine that the information systems are delivering the services necessary for the organization to conduct its business safely and soundly.
5. Determine if the board of directors or senior management has conducted an independent review, either by independent qualified staff or by an independent third-party consultant, of the current architecture, assessing the risks

associated with the institution's information technology. Did the review establish whether the organization's architecture had provided for—

a. current and long-term organizational objectives,
b. capacity requirements during normal and peak processing periods,
c. solutions when information is stored and processed in two or more separate systems,
d. the hardware's capability to run the software and its compatibility and integration with other systems and sources of data,
e. the ability to upgrade to higher levels of performance and capacity, and
f. the adequacy of controls.

6. Determine if the institution relies on information system audits or independent application reviews to determine whether information flows are accurate and complete.
7. Review, on a sample basis, the reliability, accuracy, and completeness of processed delivered information.
8. Determine whether the operating procedures and controls are commensurate with the potential for, and risks associated with, security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
9. Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with information technology for the overall banking organization and its major business activities.
10. After developing an understanding of the banking organization, assess and comment on the information technology risks and management in a scope memorandum.

2124.1.7 Appendix A—Examples of Information Technology Elements that Should Be Considered in Assessing Business Risks of Particular Situations

Situation	*IT elements to be considered*	*Potential effect on business risks*	*Risk mitigants*
A bank holding company expands very rapidly via acquisition into new product lines and geographic areas.	*Management processes.* Lack of clear, cohesive strategies could result in dependence on different systems that are incompatible and fragmented. *Integrity.* Unreliable information could be produced due to incompatible systems. *Availability.* Critical information may not be available to management when needed.	*Credit risk.* Exposure to less creditworthy borrowers may increase. *Liquidity risk.* Depositors may withdraw funds or close accounts due to unreliable account information. *Operational risk.* Controls may be inadequate to address the increase in manual interventions to correct incompatibility problems between affiliates' systems, leading to a greater potential for fraudulent transactions.	Develop a well-thought-out plan for integrating acquired systems, mapping data flows and sources, and ensuring reliability of systems.
A bank's consumer loan division inputs erroneous entries into the general-ledger system.	*Integrity.* Billing errors and unwarranted late-payment fees could occur due to the inaccurate loan information maintained by the system.	*Reputational risk.* Knowledge of errors could become widespread resulting in adverse public opinion. *Operational risk.* Increased expenditures may be required to resolve accounting operations problems. *Legal risk.* Litigation could arise because of errors in customer accounts due to processing deficiencies.	Improve policies and procedures related to input of accounting entries. Ensure internal audit considers system aspects of accounting operations.
Substantial turnover occurs in bank's wire-transfer department.	*Security.* Security procedures could be compromised due to inadequate training and lack of qualified personnel. *Integrity.* System may not be able to provide "real-time" funds availability.	*Operational risk.* Financial losses could occur due to fraud or incorrectly sent wire transfers. *Legal risk.* Litigation could arise as a result of errors in customer accounts and fraudulent wire transfers. *Reputational risk.* Knowledge of fraudulent or erroneous wire operations could result in adverse public opinion.	Increase and strengthen procedural and access controls for wire operations. Implement security measures such as passwords and firewalls. Develop and monitor appropriate audit trails. Provide for adequate training program and staffing levels.

Trading Activities of Banking Organizations (Risk Management and Internal Controls)[1] Section 2125.0

The review of risk management and internal controls is an essential element of the inspection or examination of trading activities. In view of the increasing importance of these activities to the overall risk profile and profitability of certain banking organizations,[2] this guidance highlights key considerations when inspecting or examining the risk management and internal controls of trading activities in both cash and derivative instruments.[3]

The principles set forth in this guidance apply to the risk management practices of bank holding companies, which should manage and control aggregate risk exposures on a consolidated basis while recognizing legal distinctions among subsidiaries. This guidance is specifically designed to target trading, market making, and customer accommodation activities in cash and derivative instruments at state member banks, branches and agencies of foreign banks, and Edge corporations. Many of the principles advanced can also be applied to banking organizations' use of derivatives as end-users. Examiners should assess management's application of this guidance to the holding company and to a banking organization's end-user derivative activities where appropriate, given the nature of the organization's activities and current accounting standards.

This examiner guidance is specifically provided for evaluating the following elements of an organization's risk management process for trading and derivatives activities:

- Board of directors and management oversight
- The measurement procedures, limit systems, and monitoring and review functions of the risk management process
- Internal controls and audit procedures

In assessing the adequacy of these elements at individual institutions, examiners should consider the nature and volume of a banking organization's activities and its overall approach toward managing the various types of risks involved. As with the inspection of other activities, examiner judgment plays a key role in assessing the adequacy and necessary sophistication of a banking organization's risk management system for cash and derivative instrument trading and hedging activities.

Many of the managerial practices and examiner procedures contained in this guidance are fundamental and are generally accepted as sound banking practices for both trading and nontrading activities. However, other elements may be subject to change, as both supervisory and bank operating standards evolve in response to new technologies, financial innovations, and developments in market and business practices.

2125.0.1 OVERSIGHT OF THE RISK MANAGEMENT PROCESS

As is standard practice for most banking activities, banking organizations should maintain written policies and procedures that clearly outline the organization's risk management guidance for trading and derivative activities. At a minimum these policies should identify the risk tolerances of the board of directors and should clearly delineate lines of authority and responsibility for managing the risk of these activities. Individuals throughout the trading and derivatives areas should be fully aware of all policies and procedures that relate to their specific duties.

The board of directors, senior-level management, and members of independent risk management functions are all important participants in the risk management process. Examiners should ensure that these participants are aware of their responsibilities and that they adequately perform their appropriate role in managing the risk of trading and derivative activities.

2125.0.1.1 Board of Directors' Approval of Risk Management Policies

The board of directors should approve all significant policies relating to the management of risks throughout the organization. These policies, which should include those related to trading activities, should be consistent with the organization's broader business strategies, capital adequacy, expertise, and overall willingness

1. The following is the text of SR-93-69, adapted for this manual. Section numbers have been added for reference.

2. The term "banking organizations" refers to institutions or entities that are directly supervised by the Board of Governors of the Federal Reserve System, such as state member banks and bank holding companies, including the nonbank subsidiaries of the holding company.

3. In general terms, derivative instruments are bilateral contracts or agreements whose value derives from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

to take risk. Accordingly, the board should be informed regularly of risk exposure and should regularly reevaluate significant risk management policies and procedures with special emphasis placed on those defining the institution's risk tolerance regarding these activities. The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the organization, regarding its risk management process and risk exposure.

2125.0.1.2 Senior Management's Risk Management Responsibilities

Senior management is responsible for ensuring that there are adequate policies and procedures for conducting trading operations on both a long-range and day-to-day basis. This responsibility includes ensuring that there are clear delineations of lines of responsibility for managing risk, adequate systems for measuring risk, appropriately structured limits on risk taking, effective internal controls, and a comprehensive risk-reporting process.

Senior management should regularly evaluate the procedures in place to manage risk to ensure that those procedures are appropriate and sound. Senior management should also foster and participate in active discussions with the board, with staff of risk management functions, and with traders regarding procedures for measuring and managing risk. Management must also ensure that trading and derivative activities are allocated sufficient resources and staff to manage and control risks.

2125.0.1.3 Independent Risk Management Functions

The process of measuring, monitoring, and controlling risk consistent with the established policies and procedures should be managed independently of individuals conducting trading activities, up through senior levels of the institution. An independent system for reporting exposures to both senior-level management and to the board of directors is an important element of this process.

Banking organizations should have highly qualified personnel throughout their trading and derivatives areas, including their risk management and internal control functions. The personnel staffing independent risk management functions should have a complete understanding of the risks associated with all traded on- and off-balance-sheet instruments. Accordingly, compensation policies for these individuals should be adequate to attract and retain personnel qualified to judge these risks. As a matter of general policy, compensation policies, especially in the risk management, control, and senior management functions, should be structured in a way that avoids the potential incentives for excessive risk taking that can occur if, for example, salaries are tied too closely to the profitability of trading or derivatives activities.

2125.0.2 THE RISK MANAGEMENT PROCESS

The primary components of a sound risk management process are a comprehensive risk measurement approach; a detailed structure of limits, guidelines, and other parameters used to govern risk taking; and a strong management information system for monitoring and reporting risks. These components are fundamental to both trading and nontrading activities alike. Moreover, the underlying risks associated with these activities, such as credit, market, liquidity, and operating risk, are not new to banking organizations, although their measurement and management can be somewhat more complex. Accordingly, the process of risk management for trading activities should be integrated into the organization's overall risk management system to the fullest extent possible using a conceptual framework common to its other activities. Such a common framework enables the organization to manage its consolidated risk exposure more effectively, especially since the various individual risks involved in trading activities can, at times, be interconnected and can often transcend specific markets.

As is the case with all risk-bearing activities, the risk exposures a banking organization assumes in its trading and derivatives activities should be fully supported by an adequate capital position. Banking organizations should ensure that their capital positions are sufficiently strong to support all trading and derivatives risks on a fully consolidated basis and that adequate capital is maintained in all affiliated entities engaged in these activities.

2125.0.2.1 Risk Measurement Systems

A banking organization's system for measuring

the various risks of trading and derivatives activities should be both comprehensive and accurate. Risks should be measured and aggregated across trading and nontrading activities on an organizationwide basis to the fullest extent possible.

While examiners should not require the use of a single prescribed risk measurement approach for management purposes, they should evaluate the extent to which the organization's procedures enable management to assess exposures on a consolidated basis. Examiners should also evaluate whether the risk measures and the risk measurement process are sufficiently robust to accurately reflect the multiple types of risks facing the banking organization. Risk measurement standards should be understood by relevant personnel at all levels—from individual traders to the board of directors—and should provide a common framework for limiting and monitoring risk-taking activities.

The process of marking trading and derivatives positions to market is fundamental to measuring and reporting exposures accurately and on a timely basis. Banking organizations active in dealing in foreign exchange, derivatives, and other traded instruments should have the ability to monitor credit exposures, trading positions, and market movements at least daily. Some organizations should also have the capacity, or at least the goal, of monitoring their more actively traded products on a real-time basis.

Analyzing stress situations, including combinations of market events that could affect the banking organization, is also an important aspect of risk measurement. Sound risk measurement practices include identifying possible events or changes in market behavior that could have unfavorable effects on the organization and assessing its ability to withstand them. These analyses should consider not only the likelihood of adverse events, reflecting their probability, but also plausible ''worst-case'' scenarios. Ideally, such worst-case analysis should be conducted on an organizationwide basis by taking into account the effect of unusual price changes or the default of a large counterparty across both the derivatives and cash-trading portfolios and the loan and funding portfolios.

Such stress tests should not be limited to quantitative exercises that compute potential losses or gains. They should also include more qualitative analyses of the actions management might take under particular scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

2125.0.2.2 Limiting Risks

A sound system of integrated organizationwide limits and risk-taking guidelines is an essential component of the risk management process. Such a system should set boundaries for organizational risk-taking and should also ensure that positions that exceed certain predetermined levels receive prompt management attention, so that they can be either reduced or prudently addressed. The limit system should be consistent with the effectiveness of the organization's overall risk management process and with the adequacy of its capital position. An appropriate limit system should permit management to control exposures, to initiate discussion about opportunities and risks, and to monitor actual risk-taking against predetermined tolerances, as determined by the board of directors and senior management.

Global limits should be set for each major type of risk involved. These limits should be consistent with the banking organization's overall risk measurement approach and should be integrated to the fullest extent possible with organizationwide limits on those risks as they arise in all other activities of the firm. The limit system should provide the capability to allocate limits down to individual business units.

At times, especially when markets are volatile, traders may exceed their limits. While such exceptions may occur, they should be made known to senior management and approved only by authorized personnel. These positions should also prompt discussions between traders and management about the consolidated risk-taking activities of the firm or the trading unit. The seriousness of individual or continued limit exceptions depends in large part upon management's approach toward setting limits and on the actual size of individual and organizational limits relative to the organization's capacity to take risk. Banking organizations with relatively conservative limits may encounter more exceptions to those limits than do organizations where limits may be less restrictive. Ultimately, examiners should ensure that stated policies are enforced and that the level of exposure is managed prudently.

2125.0.2.3 Reporting

An accurate, informative, and timely management information system is essential to the pru-

dent operation of a trading or derivatives activity. Accordingly, the examiner's assessment of the quality of the management information system is an important factor in the overall evaluation of the risk management process. Examiners should determine the extent to which the risk management function monitors and reports its measures of trading risks to appropriate levels of senior management and to the board of directors. Exposures and profit and loss statements should be reported at least daily to managers who supervise but do not, themselves, conduct trading activities. More frequent reports should be made as market conditions dictate. Reports to other levels of senior management and the board may occur less frequently, but examiners should determine whether the frequency of reporting provides these individuals with adequate information to judge the changing nature of the organization's risk profile.

Examiners should ensure that the management information systems translate the measured risk from a technical and quantitative format to one that can be easily read and understood by senior managers and directors, who may not have specialized and technical knowledge of trading activities and derivative products. Risk exposures arising from various products within the trading function should be reported to senior managers and directors using a common conceptual framework for measuring and limiting risks.

2125.0.2.4 Management Evaluation and Review of the Risk Management Process

Management should ensure that the various components of an organization's risk management process are regularly reviewed and evaluated. This review should take into account changes in the activities of the organization and in the market environment, since the changes may have created exposures that require additional management and examiner attention. Any material changes to the risk management system should also be reviewed.

The independent risk management functions should regularly assess the methodologies, models, and assumptions used to measure risk and to limit exposures. Proper documentation of these elements of the risk measurement system is essential for conducting meaningful reviews. The review of limit structures should compare limits to actual exposures and should also consider whether existing measures of exposure and limits are appropriate in view of the banking organization's past performance and current capital position.

The frequency and extent to which banking organizations should reevaluate their risk measurement methodologies and models depends, in part, on the specific risk exposures created by their trading activities, on the pace and nature of market changes, and on the pace of innovation with respect to measuring and managing risks. At a minimum, banking organizations with significant trading and derivative activities should review the underlying methodologies of their models at least annually—and more often as market conditions dictate—to ensure they are appropriate and consistent. Such internal evaluations may, in many cases, be supplemented by reviews by external auditors or other qualified outside parties, such as consultants who have expertise with highly technical models and risk management techniques. Assumptions should be evaluated on a continual basis.

Banking organizations should also have an effective process to evaluate and review the risks involved in products that are either new to the firm or new to the marketplace and of potential interest to the firm. In general, a banking organization should not trade a product until senior management and all relevant personnel (including those in risk management, internal control, legal, accounting, and auditing) understand the product and are able to integrate the product into the banking organization's risk measurement and control systems. Examiners should determine whether the banking organization has a formal process for reviewing new products and whether it introduces new products in a manner that adequately limits potential losses.

2125.0.2.5 Managing Specific Risks

The following discussions present examiner guidance for evaluating the specific components of a firm's risk management process in the context of each of the risks involved in trading cash and derivatives instruments.

2125.0.2.5.1 Credit Risk

Broadly defined, credit risk is the risk that a counterparty will fail to perform on an obligation to the banking organization. Banking organizations should evaluate both settlement and

presettlement credit risk at the customer level across all traded derivative and nonderivative products. On settlement day, the exposure to counterparty default may equal the full value of any cash flows or securities the banking organization is to receive. Prior to settlement, credit risk is measured as the sum of the replacement cost of the position, plus an estimate of the banking organization's potential future exposure from the instrument as a result of market changes. Replacement cost should be determined using current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, given current market conditions.

Potential credit-risk exposure is measured more subjectively than current exposure and is primarily a function of the time remaining to maturity and the expected volatility of the price, rate, or index underlying the contract. It is often assessed through simulation analysis and option-valuation models, but can also be addressed by using "add-ons," such as those included in the risk-based capital standard. In either case, examiners should evaluate the reasonableness of the assumptions underlying the banking organization's risk measure and should also ensure that banking organizations that measure exposures using a portfolio approach do so in a prudent manner.

Master netting agreements and various credit enhancements, such as collateral or third-party guarantees, can be used by banking organizations to reduce their counterparty credit risk. In such cases, a banking organization's credit exposures should reflect these risk-reducing features only to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty. Banking organizations should be able to demonstrate that they have exercised due diligence in evaluating the enforceability of these contracts and that individual transactions have been executed in a manner that provides adequate protection.

Credit limits that consider both settlement and presettlement exposures should be established for all counterparties with whom the banking organization trades. As a matter of general policy, trading with a counterparty should not commence until a credit line has been approved. The structure of the credit-approval process may differ among organizations, reflecting the organizational and geographic structure of the organization and the specific needs of its trading activities. Nevertheless, in all cases, it is important that credit limits be determined by personnel who are independent of the trading function, that these personnel use standards that are consistent with those used for nontrading activities, and that counterparty credit lines are consistent with the organization's policies and consolidated exposures.

Examiners should consider the extent to which credit limits are exceeded and whether exceptions were resolved according to the banking organization's adopted policies and procedures. Examiners should also evaluate whether the organization's reports adequately provide traders and credit officers with relevant, accurate, and timely information about the credit exposures and approved credit lines.

Trading activities that involve cash instruments often involve short-term exposures that are eliminated at settlement. However, in the case of derivative products traded in over-the-counter markets, the exposure can often exist for a period similar to that commonly associated with a loan from a banking organization. Given this potentially longer-term exposure and the complexity associated with some derivative instruments, banking organizations should consider not only the overall financial strength of the counterparty and its ability to perform on its obligation, but should also consider the counterparty's ability to understand and manage the risks inherent in the derivative product.

2125.0.2.5.2 Market Risk

Market risk is the risk to a banking organization's financial condition resulting from adverse movements in market prices. Accurately measuring a banking organization's market risk requires timely information about the current market values of its assets, liabilities, and off-balance-sheet positions. Although there are many types of market risks that can affect a portfolio's value, they can generally be described as those involving forward risk and those involving options. Forward risks arise from factors such as changing interest rates and currency exchange rates, the liquidity of markets for specific commodities or financial instruments, and local or world political and economic events. Market risks related to options include these factors as well as evolving perceptions of the volatility of price changes, the passage of time, and the interactive effect of other market risks. All of these sources of potential market risk can affect the value of the organiza-

tion and should be considered in the risk measurement process.

Market risk is increasingly measured by market participants using a value-at-risk approach, which measures the potential gain or loss in a position, portfolio, or organization that is associated with a price movement of a given probability over a specified time horizon. Banking organizations should revalue all trading portfolios and calculate their exposures at least daily. Although banking organizations may use risk measures other than value at risk, examiners should consider whether the measure used is sufficiently accurate and rigorous and whether it is adequately incorporated into the banking organization's risk management process.

Examiners should also ensure that the organization compares its estimated market-risk exposures with actual market-price behavior. In particular, the output of any market-risk models that require simulations or forecasts of future prices should be compared with actual prices. If the projected and actual results differ materially, the models should be modified, as appropriate.

Banking organizations should establish limits for market risk that relate to their risk measures and that are consistent with maximum exposures authorized by their senior management and board of directors. These limits should be allocated to business units and individual traders and be clearly understood by all relevant parties. Examiners should ensure that exceptions to limits are detected and adequately addressed by management. In practice, some limit systems may include additional elements such as stop-loss limits and trading guidelines that may play an important role in controlling risk at the trader and business-unit level; examiners should include them in their review of the limit system.

2125.0.2.5.3 Liquidity Risk

Banking organizations face two types of liquidity risk in their trading activities: those related to specific products or markets and those related to the general funding of the banking organization's trading activities. The former is the risk that a banking organization cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruptions in the marketplace. Funding-liquidity risk is the risk that the banking organization will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to trading activities, management should evaluate these risks in the broader context of the organization's overall liquidity. When establishing limits, organizations should be aware of the size, depth, and liquidity of the particular market and establish trading guidelines accordingly. Management should also give consideration to the potential problems associated with replacing contracts that terminate early in volatile or illiquid markets.

In developing guidelines for controlling the liquidity risks in trading activities, banking organizations should consider the possibility that they could lose access to one or more markets, either because of concerns about the banking organization's own creditworthiness, the creditworthiness of a major counterparty, or because of generally stressful market conditions. At such times, the banking organization may have less flexibility in managing its market-, credit-, and liquidity-risk exposures. Banking organizations that make markets in over-the-counter derivatives or that dynamically hedge their positions require constant access to financial markets, and that need may increase in times of market stress. The banking organization's liquidity plan should reflect the organization's ability to turn to alternative markets, such as futures or cash markets, or to provide sufficient collateral or other credit enhancements in order to continue trading under a broad range of scenarios.

Examiners should ensure that banking organizations that participate in over-the-counter derivative markets adequately consider the potential liquidity risks associated with the early termination of derivative contracts. Many forms of standardized contracts for derivative transactions allow counterparties to request collateral or to terminate their contracts early if the banking organization experiences an adverse credit event or a deterioration in its financial condition. In addition, under conditions of market stress, customers may ask for the early termination of some contracts within the context of the dealer's market-making activities. In such situations, a banking organization that owes money on derivative transactions may be required to deliver collateral or settle a contract early and possibly at a time when the banking organization may face other funding and liquidity pressures. Early terminations may also open up additional, unintended, market positions. Management and directors should be aware of these potential liquidity risks and should address them in the banking organization's liquidity plan and in the broader context of the

banking organization's liquidity management process. In their reviews, examiners should consider the extent to which such potential obligations could present liquidity risks to the banking organization.

2125.0.2.5.4 Operational Risk, Legal Risk, and Business Practices

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Legal risk is the risk that contracts are not legally enforceable or documented correctly. Although operating and legal risks are difficult to quantify, they can often be evaluated by examining a series of plausible "worst-case" or "what-if" scenarios, such as a power loss, a doubling of transaction volume, a mistake found in the pricing software for collateral management, or an unenforceable contract. They can also be assessed through periodic reviews of procedures, documentation requirements, data processing systems, contingency plans, and other operating practices. Such reviews may help to reduce the likelihood of errors and breakdowns in controls, improve the control of risk and the effectiveness of the limit system, and prevent unsound marketing practices and the premature adoption of new products or lines of business. Considering the heavy reliance of trading activities on computerized systems, banking organizations should have plans that take into account potential problems with their normal processing procedures.

Banking organizations should also ensure that trades that are consummated orally are confirmed as soon as possible. Oral transactions conducted via telephone should be recorded on tape and subsequently supported by written documents. Examiners should ensure that the organization monitors the consistency between the terms of a transaction as they were orally agreed upon and the terms as they were subsequently confirmed.

Examiners should also consider the extent to which banking organizations evaluate and control operating risks through the use of internal audits, stress testing, contingency planning, and other managerial and analytical techniques. Banking organizations should also have approved policies that specify documentation requirements for trading activities and formal procedures for saving and safeguarding important documents that are consistent with legal requirements and internal policies. Relevant personnel should fully understand the requirements.

Legal risks should be limited and managed through policies developed by the organization's legal counsel (typically in consultation with officers in the risk management process) that have been approved by the banking organization's senior management and board of directors. At a minimum, there should be guidelines and processes in place to ensure the enforceability of counterparty agreements. Examiners should determine whether a banking organization is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Banking organizations should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Banking organizations should further ascertain that their netting agreements are adequately documented, that they have been executed properly, and that they are enforceable in all relevant jurisdictions. Banking organizations should have knowledge of relevant tax laws and interpretations governing the use of these instruments. Knowledge of these laws is necessary not only for the banking organization's marketing activities, but also for its own use of derivative products.

Sound business practices provide that banking organizations take steps to ascertain the character and financial sophistication of counterparties. This includes efforts to ensure that the counterparties understand the nature of and the risks inherent in the agreed transactions. Where the counterparties are unsophisticated, either generally or with respect to a particular type of transaction, banking organizations should take additional steps to ensure that counterparties are made aware of the risks attendant in the specific type of transaction. While counterparties are ultimately responsible for the transactions into which they choose to enter, where a banking organization recommends specific transactions for an unsophisticated counterparty, the banking organization should ensure that it has adequate information regarding its counterparty on which to base its recommendation.

2125.0.3 INTERNAL CONTROLS AND AUDITS

A review of internal controls has long been central to the Federal Reserve's examination and inspection of trading and derivatives activities. Policies and related procedures for the operation of these activities should be an exten-

sion of the organization's overall structure of internal controls and should be fully integrated into routine work-flows. Properly structured, a system of internal controls should promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations, and banking organization policies. In determining whether internal controls meet those objectives, examiners should consider the overall control environment of the organization; the process for identifying, analyzing, and managing risk; the adequacy of management information systems; and adherence to control activities such as approvals, confirmations, and reconciliations.

Assessing the adequacy of internal controls involves a process of understanding, documenting, evaluating, and testing an organization's internal control system. This assessment should include product- or business-line reviews which, in turn, should start with an assessment of the line's organizational structure. Examiners should check for adequate separation of duties, especially between trading desk personnel and internal control and risk management functions, adequate oversight by a knowledgeable manager without day-to-day trading responsibilities, and the presence of separate reporting lines for risk management and internal control personnel on one side and for trading personnel on the other. Product-by-product reviews of management structure should supplement the overall assessment of the organizational structure of the trading and derivatives areas.

Examiners are expected to conduct in-depth reviews of the internal controls of key activities. For example, for transaction recording and processing, examiners should evaluate written policies and procedures for recording trades, assess the trading area's adherence to policy, and analyze the transaction processing cycle, including settlement, to ensure the integrity and accuracy of the banking organization's records and management reports. Examiners should review the revaluation process in order to assess the adequacy of written policies and procedures for revaluing positions and for creating any associated revaluation reserves. Examiners should review compliance with revaluation policies and procedures, the frequency of revaluation, and the independence and quality of the sources of revaluation prices, especially for instruments traded in illiquid markets. All significant internal controls associated with the management of market risk, such as position versus limit reports and limit overage approval policies and procedures, should also be reviewed. Examiners should also review the credit approval process to ensure that the risks of specific products are adequately captured and that credit approval procedures are followed for all transactions.

An important step in the process of reviewing internal controls is the examiner's appraisal of the frequency, scope, and findings of independent internal and external auditors and the ability of those auditors to review the banking organization's trading and derivatives activities. Internal auditors should audit and test the risk management process and internal controls on a periodic basis, with the frequency based on a careful risk assessment. The depth and frequency of internal audits should be increased if weaknesses and significant issues are discovered or if significant changes have been made to product lines, modeling methodologies, the risk oversight process, internal controls, or the overall risk profile of the organization.

In reviewing the risk management functions in particular, internal auditors should thoroughly evaluate the effectiveness of internal controls relevant to measuring, reporting, and limiting risks. Internal auditors should also evaluate compliance with risk limits and the reliability and timeliness of information reported to the banking organization's senior management and board of directors. Internal auditors are also expected to evaluate the independence and overall effectiveness of the banking organization's risk management functions.

The level of confidence that examiners place in the banking organization's audit programs, the nature of the audit findings, and management's response to those findings will influence the scope of the current examination of trading and derivatives activities. Even when the audit process and findings are satisfactory, examiners should document, evaluate, and test critical internal controls.

Similar to the focus of internal auditors, examiners should pay special attention to significant changes in product lines, risk measurement methodologies, limits, and internal controls that have occurred since the last examination. Meaningful changes in earnings from trading or derivatives activities, or in the size of positions or the value at risk associated with these activities, should also receive emphasis during the inspection or examination.

The following is the text of SR-95-17, adapted for this manual. Section numbers have been added for reference.

Section 2125.0, ''Trading Activities of Banking Organizations (Risk Management and Internal Controls),'' derived from SR-93-69, highlights the key elements of a sound risk-management process and emphasizes the importance of applying them to the trading and derivatives activities of banking institutions. It also provides examiners with guidance on evaluating the risk-management process and internal controls of trading activities. This section provides similar guidance on evaluating the risk-management practices used by banking institutions in acquiring and managing securities and off-balance-sheet (OBS) derivative contracts for ''nontrading'' purposes. Traditionally, these nontrading activities have been termed investment activities in the case of securities and end-user activities for OBS derivative contracts. Institutions should ensure that they employ sound risk-management practices consistently across these varying product categories regardless of legal characteristics or nomenclature.

2126.0.1 SCOPE OF NONTRADING ACTIVITIES AND GUIDANCE

This guidance specifically targets the risk-management practices of state member banks and Edge Act corporations engaged in banking. The basic principles also apply to bank holding companies, which should manage and control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries.[1] More generally, the principles advanced here set forth fundamental risk-management practices that are relevant to most portfolio-management endeavors. Institutions should review the applicability of these principles in providing trust and investment-management services.

For the purpose of this guidance, an institution's nontrading activities involve the use of securities (both available-for-sale and held-to-maturity) and OBS derivative contracts to achieve earnings and risk-management objectives that involve longer time horizons than typically associated with trading activities. Nontrading activities involve the full array of cash securities, money market instruments, and OBS derivative contracts.[2] Cash securities include fixed- and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. OBS derivative contracts include swaps, futures, and options.

2126.0.2 OVERVIEW OF GUIDANCE

This guidance reiterates and supplements existing guidance and directives on the use of these instruments for nontrading purposes as provided in various supervisory letters and examination manuals.[3] It identifies basic factors that examiners should consider in evaluating the four key elements of a sound risk-management process:

1. active board and senior management oversight
2. adequate risk-management policies and limits
3. appropriate risk-measurement and -reporting systems
4. comprehensive internal controls

1. The basic principles set forth in this guidance should also be incorporated into the policies of U.S. branches and agencies of foreign banks with appropriate adaptations to reflect the facts that (1) those offices are an integral part of a foreign bank, which should be managing its risks on a consolidated basis and recognizing possible obstacles to cash movements among branches, and (2) the foreign bank is subject to overall supervision by its home authorities.

2. In general terms, derivatives are financial contracts whose value derives from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

3. Existing policies and examiner guidance on various supervisory topics applicable to securities and off-balance-sheet instruments can be found in various chapters of the *Commercial Bank Examination Manual*, the *Bank Holding Company Supervision Manual*, the *Trust Activities Examination Manual*, the *Merchant and Investment Bank Examination Manual*, and the *Trading and Capital-Markets Activities Manual*, as well as in various supervision and regulation (SR) letters, including SR-90-16, ''Implementation of Examination Guidelines for the Review of Asset Securitization Activities''; SR-90-41, ''Interest Rate Risk''; SR-91-4, ''Inspections of Investment Adviser Subsidiaries of Bank Holding Companies'' (see section 3130.1); SR-98-12, announcement of the FFIEC *Statement on Investment Securities and End-User Derivatives Activities* (effective May 25, 1998); and SR-93-69, ''Risk Management and Internal Controls for Trading Activities'' (see section 2125.0). Examiners of U.S. branches and agencies of foreign banks should take the principles included in these guidelines into consideration in accordance with the procedures set forth in the *Examination Manual for Branches and Agencies of Foreign Banking Organizations*.

Section 2126.0.8 identifies important policy considerations related to specific risks and should receive special attention. It contains specific guidance for evaluating an institution's management of each of the risks involved in these activities, including credit, market, liquidity, operating, and legal risks.

In evaluating an institution's risk-management process, examiners should consider the nature and size of its holdings. Examiner judgment plays a key role in assessing the adequacy of an institution's risk-management process for securities and derivative contracts. Examiners should focus particular attention on evaluating an institution's understanding of the risks involved in the instruments it holds. Regardless of any responsibility, legal or otherwise, assumed by a dealer or counterparty regarding a transaction, the acquiring institution is ultimately responsible for understanding and managing the risks of the transactions into which it enters. *Failure of an institution to understand adequately the risks involved in its securities or derivative positions, either through the lack of internal expertise or inadequate outside advice, constitutes an unsafe and unsound banking practice.*

As with all risk-bearing activities, institutions should fully support the risk exposures of nontrading activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support all the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. In evaluating the adequacy of an institution's capital, examiners should consider any unrecognized net depreciation or appreciation in an institution's securities and derivative holdings.[4]

2126.0.3 BOARD OF DIRECTORS AND SENIOR MANAGEMENT OVERSIGHT

Active oversight by the institution's board of directors and relevant senior management is critical to a sound risk-management process. Examiners should ensure that these individuals are aware of their responsibilities and that they adequately perform their appropriate roles in overseeing and managing the risks associated with nontrading activities involving securities and derivative instruments.

2126.0.3.1 Board of Directors

The board of directors has the ultimate responsibility for the level of risk taken by the institution. Accordingly, the board should approve overall business strategies and significant policies that govern risk taking, including those involving securities and derivative contracts. In particular, policies identifying managerial oversight and articulating risk tolerances and exposure limits of these activities should be approved by the board of directors. The board should also actively monitor the performance and risk profile of the institution and its various securities and derivative portfolios. Directors should periodically review information that is sufficient in detail and timeliness to allow them to understand and assess the credit, market, and liquidity risks facing the institution as a whole and its securities and derivative positions in particular. Such reviews should be conducted at least quarterly and more frequently if the institution holds significant positions in complex instruments. In addition, the board should periodically reevaluate the institution's business strategies and significant risk-management policies and procedures, placing special emphasis on the institution's financial objectives and risk tolerances. The minutes of board meetings and accompanying reports and presentation materials should clearly demonstrate the board's fulfillment of these basic responsibilities. Section 2126.0.8 provides guidance on the types of objectives, risk tolerances, limits, and reports that directors should consider.

The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the institution, regarding the institution's risk-management process and risk exposures. Although it is not essential for board members to have detailed technical knowledge of these activities, if they do not, it is incumbent upon them to ensure that they have adequate access to independent legal and professional advice regarding the institution's securities and derivative holdings and strategies. The familiarity, technical knowledge, and awareness of directors and senior management should be commensurate with the level and nature of an institution's securities and derivative positions.

4. For further guidance, see SR-93-72, "Guidance on the Capital Treatment and Other Issues Relating to the Financial Accounting Standards Board Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities."

2126.0.3.2 Senior Management

Senior management is responsible for ensuring that there are adequate policies and procedures for conducting nontrading securities and derivative activities on both a long-range and day-to-day basis. Management should maintain clear lines of authority and responsibility for acquiring instruments and managing risk, appropriate limits on risk taking, adequate systems for measuring risk, acceptable standards for valuing positions and measuring performance, effective internal controls, and a comprehensive risk-reporting and risk-management review process. In order to provide adequate oversight, management should fully understand the institution's risk profile, including that of its securities and derivative activities. Examiners should review the reports to senior management and evaluate whether they provide both good summary information and sufficient detail to enable management to assess the sensitivity of securities and derivative holdings to changes in credit quality, market prices and rates, liquidity conditions, and other important risk factors. As part of its oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound. Senior management also should encourage and participate in active discussions with members of the board and with risk-management staff regarding risk measurement, reporting, and management procedures.

Management should ensure that nontrading securities and derivative activities are conducted by competent staff with technical knowledge and experience consistent with the nature and scope of the institution's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that there are sufficient back-office and financial control resources to effectively manage and control risks.

2126.0.3.3 Independence in Managing Risks

To avoid possible conflicts of interest, the process of measuring, monitoring, and controlling risks should be managed as independently as practicable from those individuals who have the authority to initiate transactions. The nature and extent of this independence should be commensurate with the size and complexity of an institution's securities and derivative activities. Institutions with large and complex balance sheets, or with significant holdings of complex instruments, would be expected to have risk managers or risk-management functions fully independent of the individuals who have the authority to conduct transactions. Institutions with less complex holdings should ensure that there is some mechanism for independently reviewing both the level of risk exposures created by securities and derivative holdings and the adequacy of the process used in managing those exposures. Depending on the size and nature of the institution, such a mechanism may reside either in the management structure or in a board committee. Regardless of size and sophistication, institutions should ensure that back- office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

2126.0.4 POLICIES AND PROCEDURES FOR ACQUIRING AND MANAGING SECURITIES AND DERIVATIVE INSTRUMENTS

Institutions should maintain written policies and procedures that clearly outline their approach for managing securities and derivative instruments. Such policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risk. They should identify relevant objectives, constraints, and guidelines for both acquiring instruments and managing portfolios. In doing so, policies should establish a logical framework for limiting the various risks involved in an institution's securities and derivative holdings. Policies should clearly delineate lines of responsibility and authority over securities and derivative activities. They should also provide for the systematic review of products new to the firm. Examiners should evaluate the adequacy of an institution's risk-management policies and procedures in relation to its size, sophistication, and the scope of its activities.

2126.0.4.1 Specifying Objectives

Institutions can use securities and derivative instruments for several primary and complemen-

tary purposes.[5] Banking organizations should clearly articulate these objectives and identify the types of securities and derivative contracts to be used for achieving them. Objectives also should be identified at the appropriate portfolio and institutional levels. These objectives should guide the acquisition of individual instruments and should provide benchmarks for periodically evaluating the performance and effectiveness of an institution's holdings, strategies, and programs. Wherever multiple objectives are involved, management should identify the hierarchy of potentially conflicting objectives.

2126.0.4.2 Identifying Constraints, Guidelines, and Limits

An institution's policies should clearly articulate the organization's risk tolerance by identifying its willingness to take the credit, market, and liquidity risks involved in holding securities and derivative contracts. A statement of authorized instruments and activities is an important vehicle for communicating these risk tolerances. This statement should clearly identify permissible instruments or instrument types and the purposes or objectives for which the institution may use them. The statement also should identify permissible credit quality, market-risk sensitivity, and liquidity characteristics of the instruments and portfolios used in nontrading activities. For example, in the case of market risk, policies should address the permissible degree of price sensitivity and/or effective maturity volatility, taking into account an instrument's or portfolio's option and leverage characteristics. Specifications of permissible risk characteristics should be consistent with the institution's overall credit, market, and liquidity risk limits and constraints and should help delineate a clear set of institutional limits for use in acquiring specific instruments and managing portfolios. Such limits can be specified either as guidelines within the overall policies or in management operating procedures. Section 2126.0.8 provides further guidance on the types of constraints and limits an institution might use in managing the credit, market, and liquidity risk of securities and derivative contracts.

Limits should be set to guide acquisition and ongoing management decisions, control exposures, and initiate discussion within the organization about apparent opportunities and risks. Although procedures for establishing limits and for operating within them may vary among institutions, examiners should determine whether the organization enforces its policies and procedures through a clearly identified system of risk limits. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to approved policies.

Limits should implement the overall risk tolerances and constraints articulated in general policy statements. Depending on the nature of an institution's holdings and its general sophistication, limits can be identified with individual business units, portfolios, instrument types, or specific instruments. The level of detail of risk limits should reflect the characteristics of the institution's holdings including the types of risk to which the institution is exposed. Regardless of their specific form or level of aggregation, limits should be consistent with the institution's overall approach to managing various types of risks. They should also be integrated to the fullest extent possible with institution-wide limits on the same risks as they arise in other activities of the firm. Section 2126.0.8 presents specific examiner considerations in evaluating the policies and limits used in managing each of the various types of risks involved in nontrading securities and derivative activities.

2126.0.4.3 New-Product Review

An institution's policies should also provide for effective review of products being considered that would be new to the firm. An institution should not acquire a meaningful position in a new instrument until senior management and all relevant personnel (including those in internal control, legal, accounting, and auditing functions) understand the product and can integrate it into the institution's risk-measurement and control systems. An institution's policies should define the terms "new product" and "meaningful position" consistent with its size, complexity, and sophistication. Institutions should not be hesitant to define an instrument as a new product. Small changes in payment formulas or other terms of relatively simple and standard products can greatly alter their risk profiles and justify the designation of an instrument as a new product. New-product reviews should analyze all of the relevant risks involved in an instru-

5. These purposes include, but are not limited to, generating earnings, creating funding opportunities, providing liquidity, hedging risk exposures, taking risk positions, modifying and managing risk profiles, managing tax liabilities, and meeting pledging requirements.

ment and should assess the reasonableness of the product or activity in achieving specified objectives. New-product reviews also should include a description of the relevant accounting guidelines and identify the procedures for measuring, monitoring, and controlling the risks involved.

2126.0.4.4 Accounting

The accounting systems and procedures used for public and regulatory reporting purposes are critically important to enhancing the transparency of an institution's risk profile. Accordingly, an institution's policies should provide clear guidelines regarding the accounting for all securities and derivative holdings. This treatment should be consistent with specified objectives and with the institution's regulatory requirements. Institutions should ensure that they categorize each cash or derivative contract for accounting purposes consistent with appropriate accounting policies and requirements. Furthermore, the accounting for nontrading securities and OBS derivative contracts should reflect the economic substance of the transactions.[6] Where instruments are used for hedging purposes, the hedging rationale and performance criteria should be well documented. Management should reassess these classifications periodically to ensure that they remain appropriate.[7]

2126.0.5 RISK MEASUREMENT, MONITORING SYSTEMS, AND MANAGEMENT REVIEW

Clear procedures for measuring and monitoring risks are the foundation of a sound risk-management process. Examiners should ensure that an institution sufficiently integrates these functions into its ongoing management process and that relevant personnel recognize their role and understand the instruments held.

2126.0.5.1 Risk Measurement

An institution's system for measuring the credit, market, liquidity, and other risks involved in cash and derivative contracts should be as comprehensive and accurate as practicable. The degree of comprehensiveness should be commensurate with the nature of the institution's holdings and risk exposures. Exposures to each type of risk (that is, credit, market, liquidity) should be aggregated across securities and derivative contracts and integrated with similar exposures arising from lending and other business activities to obtain the institution's overall risk profile.

Examiners should evaluate whether the risk measures and the risk-measurement process are sufficiently robust to accurately reflect the different types of risks facing the institution. Institutions should establish clear risk-measurement standards for both the acquisition and ongoing management of securities and derivative positions. Risk-measurement standards should provide a common framework for limiting and monitoring risks and should be understood by relevant personnel at all levels of the institution—from individual managers to the board of directors.

2126.0.5.1.1 Acquisition Standards

Institutions conducting securities and derivative activities should have the capacity to evaluate the risks of instruments before acquisition. Before executing any transaction, an institution should evaluate the instrument to ensure that it meets the various objectives, risk tolerances, and guidelines identified by the institution's policies. Evaluations of the credit-, market-, and liquidity-risk exposures should be clearly and adequately documented for each acquisition. Such documentation should be appropriate for the nature and type of instrument. Relatively simple instruments would be expected to require less documentation than instruments with significant leverage or option characteristics.

Institutions with significant securities and derivative activities are expected to either conduct their own in-house preacquisition analyses or make use of specific third-party analyses that are independent of the seller or counterparty. Analyses provided by the originating dealer or counterparty should be used only when there is a clearly defined investment advisory relationship. Less active institutions with relatively uncomplicated holdings may use risk analyses provided by the dealer only to the extent that the analyses are derived using standard industry

6. Adjusted trading involves the sale of an instrument at a price above the prevailing market value and the simultaneous purchase and booking of an instrument at a price greater than its market value.

7. Reporting requirements for bank and bank holding company regulatory reports are set forth in the Reports of Condition and Income (call report) for banks and the FR Y-9C for bank holding companies.

calculators and market conventions. Such analyses must comprehensively depict the potential risks involved in the acquisition, and they should be accompanied by documentation that sufficiently demonstrates that the acquirer understands fully both the analyses and the nature of the institution's relationship with the provider of those analyses. Notwithstanding information and analyses obtained from outside sources, management is ultimately responsible for understanding the nature and risk profiles of the institution's securities and derivative holdings.

It is a prudent practice to obtain and compare price quotes and risk analyses from more than one dealer before acquisition. In doing so, institutions should ensure that they clearly understand the responsibilities of any outside parties that provide analyses and price quotes. With regard to analyses and price quotes provided by dealers, institutions should assume that each party deals at arm's length for its own account unless there is a written agreement stating the contrary. Institutions should exercise caution in situations in which dealers limit the institution's ability to show securities or derivative contract proposals to other dealers in order to receive comparative price quotes or risk analyses. As a general sound practice, unless the dealer or counterparty is also acting under a specific investment advisory relationship, an investor or end-user should not acquire an instrument or enter into a transaction if its fair value or the analyses required to assess its risk cannot be determined through a means that is independent of the originating dealer or counterparty.

2126.0.5.1.2 Portfolio-Management Standards

Institutions should periodically review the performance and effectiveness of instruments, portfolios, and institutional programs and strategies. This review should be conducted no less frequently than quarterly and should evaluate the extent to which the institution's securities and derivative holdings meet the various objectives, risk tolerances, and guidelines established by the institution's policies.[8] Institutions with large or highly complex holdings should conduct such reviews more frequently.

For internal measurement purposes, effective measurement of the credit, market, and liquidity risks of many securities and derivative contracts requires mark-to-market valuations.[9] Accordingly, the periodic revaluation of securities and derivative holdings is an integral part of an effective risk-measurement system. These periodic revaluations should be fully documented. Where available, actual market prices should be used. For less liquid or complex instruments, institutions with only limited holdings may use properly documented periodic prices and analyses provided by dealers or counterparties. More active institutions should conduct periodic revaluations and portfolio analyses using either their own in-house capabilities or outside party analytical systems that are independent of sellers or counterparties. Institutions should recognize that indicative price quotes and model revaluations may differ from the values at which transactions can be executed.

2126.0.5.1.3 Stress Testing

Analyzing the credit, market, and liquidity risk of individual instruments, portfolios, and the entire institution under a variety of unusual and stressful conditions is an important aspect of the risk-measurement process. Management should seek to identify the types of situations, or the combinations of credit and market events, that could produce substantial losses or liquidity problems. Since institutions typically manage nontrading securities and derivative contracts with consideration to the institution's consolidated exposures, management should review the effect of stress situations on an institution-wide basis. Stress tests should evaluate changes in market conditions, including alternatives in the underlying assumptions used to value instruments.

Stress tests should not be limited to quantitative exercises that compute potential losses or gains, but should also include qualitative analyses of the tools available to management to deal with various scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

8. For example, the performance of instruments and portfolios used to meet tax-advantaged earnings objectives should be evaluated to ensure that they meet the necessary credit rating, market sensitivity, and liquidity characteristics established for this objective.

9. The Reports of Condition and Income (call report) require quarterly reporting of the fair value of all securities holdings.

The appropriate extent and sophistication of an institution's stress testing depends heavily on the scope and nature of its securities and derivative holdings and on its ability to limit the effect of adverse events. Institutions holding securities or derivative contracts with complex credit-, market-, or liquidity-risk profiles should have an established regime of stress testing. Examiners should consider the circumstances at each institution when evaluating the adequacy or need for stress-testing procedures.

2126.0.5.2 Risk Reporting

An accurate, informative, and timely management information system is essential. Examiners should evaluate the adequacy of an institution's monitoring and reporting of the risks, returns, and overall performance of security and derivative activities to senior management and the board of directors. The frequency of reporting should provide the responsible individuals with adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

Management reports should translate measured risks from technical and quantitative formats to those that can be easily read and understood by senior managers and directors, who may not have specialized and technical knowledge of all financial instruments used by the institution. Institutions should ensure that they use a common conceptual framework for measuring and limiting risks in reports to senior managers and directors. Such reports should include the periodic assessment of the performance of appropriate instruments or portfolios in meeting their stated objective(s) subject to the relevant constraints and risk tolerances.

2125.0.5.3 Management Evaluation and Review

Management should regularly review the institution's approach and process for managing risks. This includes regularly assessing the methodologies, models, and assumptions used to measure risks and to limit exposures. Proper documentation of the elements used in measuring risks is essential for conducting meaningful reviews. Limits should be compared to actual exposures. Such reviews should also consider whether existing measures of exposure and limits are appropriate in view of the institution's holdings, past performance, and current capital position.

The frequency of the reviews should reflect the nature of an institution's holdings and the pace of market innovations in measuring and managing risks. At a minimum, institutions with significant activities involving complex cash or derivative contracts should review the underlying methodologies of the models they use at least annually—and more often as market conditions dictate—to ensure that they are appropriate and consistent. Reviews by external auditors or other qualified outside parties, such as consultants with expertise in highly technical models and risk-management techniques, may often supplement these internal evaluations. Institutions depending on outside parties to provide various risk-measurement capabilities should ensure that the institution has personnel with the necessary expertise to identify and evaluate the important assumptions incorporated in the risk-measurement methodologies it uses.

2126.0.6 COMPREHENSIVE INTERNAL CONTROLS AND AUDIT PROCEDURES

An institution's risk-management process should be an extension of its overall structure of internal controls. Properly structured, a system of internal controls should promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations, and institutional policies. In determining whether internal controls meet those objectives, examiners should consider the general control environment of the organization; the process for identifying, analyzing, and managing risk; the adequacy of management information systems; and adherence to control activities such as approvals, confirmations, and reconciliations.

Assessing the adequacy of internal controls involves a process of understanding, documenting, evaluating, and testing an institution's internal control system. This assessment should include product reviews that start with an analysis of the organizational structure of securities and derivative activities. Duties should be separated between personnel initiating transactions and personnel overseeing back-office operations, internal controls, and the management of risk exposures.

Examiners should conduct in-depth reviews of the internal controls of all key activities involving securities and derivative contracts. For example, for transaction recording and processing, examiners should evaluate and assess adherence to the written policies and procedures for recording transactions. They should also analyze the transaction-processing cycle to ensure the integrity and accuracy of the institution's records and management reports. Examiners should review all significant internal controls associated with the management of the credit, market, liquidity, operational, and legal risks involved in securities and derivative holdings.

The examiner should appraise the frequency, scope, and findings of any independent internal and external auditors. This appraisal should include an evaluation of the ability of those auditors to review the institution's securities and derivative activities. Where applicable, internal auditors should audit and test the risk-management process and internal controls periodically. The depth and frequency of internal audits should increase if weaknesses and significant issues exist or if portfolio structures, modeling methodologies, or the overall risk profile of the institution has changed.

In reviewing the management of the risks of nontrading securities and derivative activities, internal auditors should thoroughly evaluate the effectiveness of internal controls used for measuring, reporting, and limiting risks. Internal auditors should also evaluate compliance with risk limits and the reliability and timeliness of information reported to the institution's senior management and board of directors. Internal auditors should also evaluate the independence and overall effectiveness of the institution's risk-management process. The level of confidence that examiners place in an institution's audit programs, the nature of the audit findings, and management's response to those findings will influence the scope of the current examination of securities and derivative activities.

Examiners should pay special attention to significant changes in the nature of instruments acquired, risk-measurement methodologies, limits, and internal controls that have occurred since the last examination. Significant changes in earnings from securities and derivative contracts, in the size of positions, or in the value at risk associated with these activities should also receive attention during the examination.

2126.0.7 SOUND RISK MANAGEMENT FOR MANAGING SECURITIES AND DERIVATIVE CONTRACTS—CONCLUSION

The foregoing discussion identified, in broad terms, the key elements of a sound risk-management system for acquiring and managing securities and derivative contracts. Section 2126.0.8 presents important guidance for evaluating specific risks—credit, market, liquidity, operating, and legal—that institutions encounter in conducting nontrading securities and derivative activities.

These guidelines, including those in section 2126.0.8, are intended to help examiners, and the management and boards of directors of institutions, evaluate the adequacy of the risk-management process as it applies to the use of securities and derivative contracts in a nontrading environment. However, the nature of these activities and the broad range of circumstances in which these instruments are used by banking organizations requires examiners to apply substantial judgment in their evaluation of management procedures. In the final analysis, *examiners must determine whether the institution's use of securities and derivatives represents a prudent activity in light of the purposes for which they are used, management's ability to evaluate and control risks, and the capital position of the institution.* They should also ensure that depository institutions adopt adequate policies related to securities and derivative transactions and that all levels of management provide sufficient oversight of the risk-management process.

2126.0.8 EVALUATING THE MANAGEMENT OF THE CREDIT, MARKET, LIQUIDITY, OPERATING, AND LEGAL RISKS OF NONTRADING SECURITIES AND DERIVATIVE ACTIVITIES

This section highlights specific considerations in evaluating the key elements of sound risk-management systems as they relate to the management of the various risks involved in an institution's use of securities and derivative contracts for nontrading activities. These risks include credit, market, liquidity, operating, and legal risks.

2126.0.8.1 Credit Risk

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. The policies of an institution should recognize credit risk as a significant risk faced by the institution's securities and derivative activities. Accordingly, policies should identify credit-risk constraints, risk tolerances, and limits at the appropriate instrument, portfolio, and institutional level. In doing so, institutions should ensure that credit-risk constraints are clearly associated with specified objectives. For example, credit-risk constraints and guidelines should be defined for instruments used to meet pledging requirements, to generate tax-advantaged income, to hedge positions, and to generate temporary income or any other specifically defined objective.

As a matter of general policy, an institution should not acquire securities or derivative contracts until it has assessed the creditworthiness of the issuer or counterparty and determined that the risk exposure conforms with its policies. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution to the fullest extent possible. As a matter of policy, the board of directors and responsible senior management should be informed of the institution's total credit-risk exposures regularly, and no less frequently than quarterly.

In managing their credit risk, institutions also should consider settlement and presettlement credit risk. The selection of dealers, investment bankers, and brokers is particularly important in effectively managing these risks. An institution's policies should identify criteria for selecting these organizations and should list all approved firms. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. The board of directors, or a committee thereof, should set limits on the amounts and types of transactions authorized for each firm. They should also periodically review and reconfirm the list of authorized dealers, investment bankers, and brokers. See section 2190.0.5 for a discussion of SR-98-12 regarding the FFIEC *Statement on Investment Securities and End-User Derivatives Activities* (effective May 25, 1998).

An institution's credit policies should also include guidelines on the quality and quantity of each type of security that may be held. Policies should also provide credit-risk diversification and concentration limits. Such limits may define concentrations as those to a single or related issuer or counterparty, in a geographical area, or in obligations with similar characteristics.

Sound credit-risk management requires that credit limits be developed by personnel who are independent of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution, and with the organization's overall policies and consolidated exposures. In assessing the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should also perform their own analysis of a counterparty's or issuer's financial strength. In addition, examiners should review the credit-approval process to ensure that the credit risks of specific products are adequately identified and that credit-approval procedures are followed for all transactions.

For most cash instruments, credit exposure is measured as the current carrying value. In the case of many derivative contracts, especially those traded in OTC markets, credit exposure is measured as the replacement cost of the position, plus an estimate of the institution's potential future exposure to changes in the replacement value of that position in response to market-price changes. Replacement costs of derivative contracts should be determined using current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, at current market rates.

The measurement of potential future credit-risk exposure for derivative contracts is more subjective than the measurement of current exposure and is primarily a function of the time remaining to maturity, the number of exchanges of principal, and the expected volatility of the price, rate, or index underlying the contract. Potential future exposure can be measured using an institution's own simulations or, more simply, through the use of ''add-ons'' such as those included in the Federal Reserve's risk-based capital guidelines. Regardless of method, examiners should evaluate the reasonableness of the assumptions underlying the institution's risk measure.

For derivative contracts and certain types of cash transactions, master agreements (including netting agreements) and various credit enhance-

ments (such as collateral or third-party guarantees) can reduce settlement, issuer, and counterparty credit risk. In such cases, an institution's credit exposures should reflect these risk-reducing features only to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty. Institutions should be prepared to demonstrate sufficient due diligence in evaluating the enforceability of these contracts.

In reviewing credit exposures, examiners should consider the extent to which positions exceed credit limits and whether exceptions are resolved according to the institution's adopted policies and procedures. Examiners should also evaluate whether the institution's reports adequately provide all personnel involved in the acquisition and management of financial instruments with relevant, accurate, and timely information about the credit exposures and approved credit lines.

2126.0.8.2 Market Risk

Market risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates and/or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. Although many banking institutions focus on carrying values and reported earnings when assessing market risk at the institutional level, other measures focusing on total returns and changes in economic or fair values better reflect the potential market-risk exposure of institutions, portfolios, and individual instruments. Changes in fair values and total returns directly measure the effect of market movements on the economic value of an institution's capital and provide significant insights as to their ultimate effects on the institution's long-term earnings. Institutions should manage and control their market risks using both an earnings and an economic-value approach and at least on an economic- or fair-value basis.

When evaluating capital adequacy, examiners should consider the effect of changes in market rates and prices on the economic value of the institution by evaluating any unrealized losses in an institution's securities or derivative positions. This evaluation should assess the ability of the institution to hold its positions and function as a going concern if recognition of unrealized losses would significantly affect the institution's capital ratios. Examiners also should consider the impact that liquidating positions with unrealized losses may have on the institution's prompt-corrective-action capital category.

Market-risk limits should be established for both the acquisition and ongoing management of an institution's securities and derivative holdings and, as appropriate, should address exposures for individual instruments, instrument types, and portfolios. These limits should be integrated fully with limits established for the entire institution. At the institutional level, the board of directors should approve market-risk exposure limits in terms of specific percentage changes in the economic value of capital and in the projected earnings of the institution under various market scenarios. Similar and complementary limits on the volatility of prices or fair value should be established at the appropriate instrument, product type, and portfolio levels based on the institution's willingness to accept market risk. Limits on the variability of effective maturities may also be desirable for certain types of instruments or portfolios.

The federal bank regulatory agencies have established price and effective maturity standards for mortgage-derivative products based on specified scenarios. Institutions should ensure that they meet these regulatory requirements and should employ similar techniques in controlling the exposures of other cash securities and to all derivative contracts—especially for instruments involving explicit or embedded options. The scenarios specified for assessing the market risk of these products should be sufficiently rigorous to capture all meaningful effects of any options. For example, in assessing interest-rate risk, scenarios such as 100, 200, and 300 basis point parallel shifts in yield curves should be considered as well as appropriate nonparallel shifts in structure to evaluate potential basis, volatility, and yield curve risks.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its securities and derivative holdings. Accordingly, institutions should have market-risk-measurement systems commensurate with the size and nature of these holdings. Institutions with significant holdings of highly complex instruments should ensure that they have independent means to value their positions. Institutions employing

internal models should have adequate procedures to validate the models and to periodically review all elements of the modeling process, including its assumptions and risk-measurement techniques. Institutions relying on third parties for market-risk-measurement systems and analyses should ensure that they fully understand the assumptions and techniques used.

Institutions should evaluate and report to their boards of directors the market-risk exposures of their securities and derivative positions on a regular basis and not less frequently than each quarter. These evaluations should assess trends in aggregate market-risk exposure and the performance of portfolios in terms of established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Examiners should ensure that institutions have mechanisms to detect and adequately address exceptions to limits and guidelines. Examiners should also determine if management reports on market risk appropriately address potential exposures to basis risk, yield curve changes, and other factors pertinent to the institution's holdings. In this connection, examiners should assess an institution's compliance with broader guidance for managing interest-rate risk in a consolidated organization, including that detailed in the *Commercial Bank Examination Manual*.

Complex and illiquid instruments can often involve greater market risk than broadly traded, more liquid securities. Oftentimes, this higher potential market risk arising from illiquidity is not captured by standardized financial modeling techniques. Such risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for such instruments can evaporate. Where examiners encounter such instruments, they should review the adequacy with which the institution has assessed its potential market risks. If the risks from these instruments are material, the institution should have a well-documented process of stress testing their value and liquidity assumptions under a variety of market scenarios.

2126.0.8.3 Liquidity Risk

Banks face two types of liquidity risk in their securities and derivative activities: those related to specific products or markets and those related to the general funding of the bank's activities. The former, market liquidity risk, is the risk that an institution cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruptions in the marketplace. Funding liquidity risk is the risk that the bank will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to securities and derivative activities, management should evaluate these risks in the broader context of the institution's overall liquidity.

In specifying permissible securities and derivative instruments for accomplishing established objectives, institutions should ensure that they take into account the size, depth, and liquidity of the market for those instruments and the effect that such characteristics may have on achieving the objective. The market liquidity of certain types of instruments may make them entirely inappropriate for achieving certain objectives. Moreover, institutions should ensure that they consider the effects that market risk can have on the liquidity of different types of instruments. For example, some government-agency securities may have embedded options that make them highly illiquid during periods of market volatility and stress, despite their high credit rating. Accordingly, institutions should clearly articulate the market liquidity characteristics of instruments to be used in accomplishing institutional objectives.

The funding risk of an institution becomes a more important consideration when its unrealized losses are material and, therefore, should be a factor in evaluating capital adequacy. Institutions with weak liquidity positions are more likely to be forced to recognize these losses and to suffer declines in their accounting and regulatory capital. In extreme cases, these effects could force supervisors to take prompt corrective actions.

Examiners should assess whether the institution adequately considers the potential liquidity risks associated with the liquidation of securities or the early termination of derivative contracts. Many forms of standardized contracts for derivative transactions allow counterparties to request collateral or to terminate their contracts early if the institution experiences an adverse credit event or a deterioration in its financial condition. In addition, under situations of market stress, customers may ask for the early termination of some contracts within the context of

the dealer's market-making activities. In such circumstances, an institution that owes money on derivative transactions may be required to deliver collateral or settle a contract early and possibly at a time when the institution may face other funding and liquidity pressures. Early terminations may also open additional, unintended market positions. Management and directors should be aware of these potential liquidity risks and should address them in the institution's liquidity plan and in the broader context of the institution's liquidity-management process. In their reviews, examiners should consider the extent to which such potential obligations could present liquidity risks to the institution.

2126.0.8.4 Operating Risk and Legal Risk

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk that can result in unexpected losses include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in securities and derivative activities.

Adequate internal controls are the first line of defense in controlling the operating risks involved in an institution's securities and derivatives activities. Of particular importance are internal controls that ensure the separation of duties and supervision of persons executing transactions from those responsible for processing contracts, confirming transactions, controlling various clearing accounts, approving the accounting methodology or entries, and performing revaluations.

Institutions should have approved policies that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents that are consistent with legal requirements and internal policies. Relevant personnel should fully understand the requirements. Examiners should also consider the extent to which institutions evaluate and control operating risks through the use of internal audits, stress testing, contingency planning, and other managerial and analytical techniques.

An institution's operating policies should establish appropriate procedures to obtain and maintain possession or control of instruments purchased. Institutions should also ensure that transactions consummated orally are confirmed as soon as possible. Banking organizations should, to the extent possible, seek diversification with regard to the firms used for safekeeping arrangements in order to avoid concentrations of assets or other types of risk.[10]

Legal risk is the risk that contracts are not legally enforceable or documented correctly. Legal risks should be limited and managed through policies developed by the institution's legal counsel. At a minimum, there should be guidelines and processes in place to ensure the enforceability of counterparty agreements. Examiners should determine whether an institution is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Institutions should further ascertain that their netting agreements are adequately documented, that they have been executed properly, and that they are enforceable in all relevant jurisdictions. Institutions should have knowledge of relevant tax laws and interpretations governing the use of these instruments.

An institution's policies should also provide guidelines for conflicts of interest for employees who are directly involved in purchasing and selling securities for the institution from securities dealers. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board of directors may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with these same securities firms without specific prior board approval. The board of directors may also wish to adopt a policy applicable to directors, officers, and employees restricting or prohibiting the receipt of gifts, gratuities, or travel expenses from approved securities dealer firms and their personnel.

10. See SR-95-3 for further guidance on safekeeping.

On April 23, 1998, the Federal Financial Institutions Examination Council (FFIEC) issued a Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities that became effective on May 25, 1998. The statement was adopted by the Board of Governors and provides guidance on sound practices for managing the risks of investment activities. This statement replaced the 1992 Supervisory Policy Statement on Securities Activities, including the constraints on bank investments in "high-risk" mortgage investment products (the FFIEC "high-risk test"). The guidance focuses on risk-management practices of state member banks and Edge corporations. The basic principles also apply to bank holding companies, which should manage and control risk exposures on a consolidated basis, recognizing the legal distinctions and potential obstacles to cash movements among subsidiaries. The statement's risk-management principles should also be incorporated into the policies of U.S. branches and agencies of foreign banks.[1]

The statement's principles set forth sound risk-management practices that are relevant to most portfolio-management endeavors. The statement places greater emphasis on a risk-focused approach to supervision. Instruments held for end-user reasons are considered, taking into consideration a variety of factors such as management's ability to manage and measure risk within the institution's holdings and the impact of those holdings on aggregate portfolio risk.

The statement focuses on managing the market, credit, liquidity, operational, and legal risks of investment and end-user activities. When managing the interest-rate-risk component of market risk, institutions are informed of the merits of developing internal policies that specify the type of pre-acquisition analysis (stress testing) that is consistent with the scope, sophistication, and complexity of their investment securities and end-user derivative holdings. Such analyses should be conducted for certain types of instruments, including those that have complex or potentially volatile risk profiles. Institutions are advised to periodically monitor the price sensitivity of their portfolios, ensuring that they meet the established limits of the board of directors. Institutions are further advised to fully assess the creditworthiness of their counterparties, including brokers and issuers. Institutions are to ensure that they take proper account of the liquidity of the instruments held. (See SR-98-12.)

The principles set forth within this interagency policy statement are derived generally from those set forth in SR-95-17. See section 2126.0 and the appropriate sections of the *Trading and Capital-Markets Activities Manual.* The policy statement, as written, follows. The section numbers have been added for reference.

2126.1.1 SUPERVISORY POLICY STATEMENT ON INVESTMENT SECURITIES AND END-USER DERIVATIVES ACTIVITIES

2126.1.1.1 Purpose

This policy statement (statement) provides guidance to financial institutions (institutions) on sound practices for managing the risks of investment securities and end-user derivatives activities.[2] The FFIEC agencies—the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration—believe that effective management of the risks associated with securities and derivative instruments represents an essential component of safe and sound practices. This guidance describes the practices that a prudent manager normally would follow and is not intended to be a checklist. Management should establish practices and maintain documentation appropriate to the institution's individual circumstances, consistent with this statement.

2126.1.1.2 Scope

This guidance applies to all securities in *held-to-maturity* and *available-for-sale* accounts as defined in the Statement of Financial Accounting Standards No.115 (FAS 115), certificates of

1. Appropriate adaptations should be made to reflect the fact that (1) those offices are an integral part of a foreign bank that must also manage its consolidated risks and recognize possible obstacles to cash movement among branches; and (2) the foreign bank is subject to overall supervision by its home-country supervisory authority.

2. The 1998 statement does not supersede any other requirements of the respective agencies' statutory rules, regulations, policies, or supervisory guidance.

deposit held for investment purposes, and end-user derivative contracts not held in trading accounts. This guidance covers all securities used for investment purposes, including money market instruments, fixed-rate and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. Similarly, this guidance covers all end-user derivative instruments used for nontrading purposes, such as swaps, futures, and options.[3] This statement applies to all federally insured commercial banks, savings banks, savings associations, and federally chartered credit unions.

As a matter of sound practice, institutions should have programs to manage the market, credit, liquidity, legal, operational, and other risks of investment securities and end-user derivatives activities (investment activities). While risk-management programs will differ among institutions, there are certain elements that are fundamental to all sound risk-management programs. These elements include board and senior management oversight and a comprehensive risk-management process that effectively identifies, measures, monitors, and controls risk. This statement describes sound principles and practices for managing and controlling the risks associated with investment activities.

Institutions should fully understand and effectively manage the risks inherent in their investment activities. *Failure to understand and adequately manage the risks in these areas constitutes an unsafe and unsound practice.*

2126.1.1.3 Board and Senior Management Oversight

Board of director and senior management oversight is an integral part of an effective risk-management program. The board of directors is responsible for approving major policies for conducting investment activities, including the establishment of risk limits. The board should ensure that management has the requisite skills to manage the risks associated with such activities. To properly discharge its oversight responsibilities, the board should review portfolio activity and risk levels, and require management to demonstrate compliance with approved risk limits. Boards should have an adequate understanding of investment activities. Boards that do not should obtain professional advice to enhance its understanding of investment-activity oversight, so as to enable it to meet its responsibilities under this statement.

Senior management is responsible for the daily management of an institution's investments. Management should establish and enforce policies and procedures for conducting investment activities. Senior management should have an understanding of the nature and level of various risks involved in the institution's investments and how such risks fit within the institution's overall business strategies. Management should ensure that the risk-management process is commensurate with the size, scope, and complexity of the institution's holdings. Management should also ensure that the responsibilities for managing investment activities are properly segregated to maintain operational integrity. Institutions with significant investment activities should ensure that back-office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

2126.1.1.4 Risk-Management Process

An effective risk-management process for investment activities includes (1) policies, procedures, and limits; (2) the identification, measurement, and reporting of risk exposures; and (3) a system of internal controls.

2126.1.1.4.1 Policies, Procedures, and Limits

Investment policies, procedures, and limits provide the structure to effectively manage investment activities. Policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and risk tolerance. Policies should identify relevant investment objectives, constraints, and guidelines for the acquisition and ongoing management of securities and derivative instruments. Potential investment objectives include generating earnings; providing liquidity; hedging risk exposures; taking risk positions; modifying and managing risk profiles; managing tax liabilities; and meeting pledging requirements, if applicable. Policies should also identify the risk charac-

3. Natural-person federal credit unions are not permitted to purchase non-residential mortgage asset-backed securities and may participate in derivative programs only if authorized by the NCUA.

teristics of permissible investments and should delineate clear lines of responsibility and authority for investment activities.

An institution's management should understand the risks and cash-flow characteristics of its investments. This is particularly important for products that have unusual, leveraged, or highly variable cash flows. An institution should not acquire a material position in an instrument until senior management and all relevant personnel understand and can manage the risks associated with the product.

An institution's investment activities should be fully integrated into any institution-wide risk limits. In so doing, some institutions rely only on the institution-wide limits, while others may apply limits at the investment portfolio, subportfolio, or individual instrument level.

The board and senior management should review, at least annually, the appropriateness of its investment strategies, policies, procedures, and limits.

2126.1.1.4.2 Risk Identification, Measurement, and Reporting

Institutions should ensure that they identify and measure the risks associated with individual transactions prior to acquisition and periodically after purchase. This can be done at the institutional, portfolio, or individual-instrument level. Prudent management of investment activities entails examination of the risk profile of a particular investment in light of its impact on the risk profile of the institution. To the extent practicable, institutions should measure exposures to each type of risk, and these measurements should be aggregated and integrated with similar exposures arising from other business activities to obtain the institution's overall risk profile.

In measuring risks, institutions should conduct their own in-house pre-acquisition analyses, or to the extent possible, make use of specific third-party analyses that are independent of the seller or counterparty. Irrespective of any responsibility, legal or otherwise, assumed by a dealer, counterparty, or financial advisor regarding a transaction, the acquiring institution is ultimately responsible for the appropriate personnel understanding and managing the risks of the transaction.

Reports to the board of directors and senior management should summarize the risks related to the institution's investment activities and should address compliance with the investment policy's objectives, constraints, and legal requirements, including any exceptions to established policies, procedures, and limits. Reports to management should generally reflect more detail than reports to the board of the institution. Reporting should be frequent enough to provide timely and adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

2126.1.1.4.3 Internal Controls

An institution's internal control structure is critical to the safe and sound functioning of the organization generally and the management of investment activities in particular. A system of internal controls promotes efficient operations; reliable financial and regulatory reporting; and compliance with relevant laws, regulations, and institutional policies. An effective system of internal controls includes enforcing official lines of authority, maintaining appropriate separation of duties, and conducting independent reviews of investment activities.

For institutions with significant investment activities, internal and external audits are integral to the implementation of a risk-management process to control risks in investment activities. An institution should conduct periodic independent reviews of its risk-management program to ensure its integrity, accuracy, and reasonableness. Items that should be reviewed include—

1. compliance with and the appropriateness of investment policies, procedures, and limits;
2. the appropriateness of the institution's risk-measurement system given the nature, scope, and complexity of its activities; and
3. the timeliness, integrity, and usefulness of reports to the board of directors and senior management.

The review should note exceptions to policies, procedures, and limits and suggest corrective actions. The findings of such reviews should be reported to the board and corrective actions taken on a timely basis.

The accounting systems and procedures used for public and regulatory reporting purposes are critically important to the evaluation of an organization's risk profile and the assessment of its financial condition and capital adequacy. Accordingly, an institution's policies should provide clear guidelines regarding the reporting

treatment for all securities and derivatives holdings. This treatment should be consistent with the organization's business objectives, generally accepted accounting principles (GAAP), and regulatory reporting standards.

2126.1.1.5 Risks of Investment Activities

The following discussion identifies particular sound practices for managing the specific risks involved in investment activities. In addition to these sound practices, institutions should follow any specific guidance or requirements from their primary supervisor related to these activities.

2126.1.1.5.1 Market Risk

Market risk is the risk to an institution's financial condition resulting from adverse changes in the value of its holdings arising from movements in interest rates, foreign-exchange rates, equity prices, or commodity prices. An institution's exposure to market risk can be measured by assessing the effect of changing rates and prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. For most institutions, the most significant market risk of investment activities is interest-rate risk.

Investment activities may represent a significant component of an institution's overall interest-rate-risk profile. It is a sound practice for institutions to manage interest-rate risk on an institution-wide basis. This sound practice includes monitoring the price sensitivity of the institution's investment portfolio (changes in the investment portfolio's value over different interest-rate/yield curve scenarios). Consistent with agency guidance, institutions should specify institution-wide interest-rate-risk limits that appropriately account for these activities and the strength of the institution's capital position. These limits are generally established for economic value or earnings exposures. Institutions may find it useful to establish price-sensitivity limits on their investment portfolio or on individual securities. These sub-institution limits, if established, should also be consistent with agency guidance.

It is a sound practice for an institution's management to fully understand the market risks associated with investment securities and derivative instruments prior to acquisition and on an ongoing basis. Accordingly, institutions should have appropriate policies to ensure such understanding. In particular, institutions should have policies that specify the types of market-risk analyses that should be conducted for various types or classes of instruments, including that conducted prior to their acquisition (pre-purchase analysis) and on an ongoing basis. Policies should also specify any required documentation needed to verify the analysis.

It is expected that the substance and form of such analyses will vary with the type of instrument. Not all investment instruments may need to be subjected to a pre-purchase analysis. Relatively simple or standardized instruments, the risks of which are well known to the institution, would likely require no or significantly less analysis than would more volatile, complex instruments.[4]

For relatively more complex instruments, less familiar instruments, and potentially volatile instruments, institutions should fully address pre-purchase analyses in their policies. Price-sensitivity analysis is an effective way to perform the pre-purchase analysis of individual instruments. For example, a pre-purchase analysis should show the impact of an immediate parallel shift in the yield curve of plus and minus 100, 200, and 300 basis points. Where appropriate, such analysis should encompass a wider range of scenarios, including nonparallel changes in the yield curve. A comprehensive analysis may also take into account other relevant factors, such as changes in interest-rate volatility and changes in credit spreads.

When the incremental effect of an investment position is likely to have a significant effect on the risk profile of the institution, it is a sound practice to analyze the effect of such a position on the overall financial condition of the institution.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its investments. Accordingly, institutions should have market-risk-measurement systems commensurate with the size and nature of these investments. Institutions with significant holdings of highly complex instruments should ensure that they have the means to value their positions. Institutions employing internal models should have adequate procedures to validate the models and to periodically review all elements of the modeling process, including its assumptions and

4. Federal credit unions must comply with the investment-monitoring requirements of 12 C.F.R. 703.90. See 62 FR 32989 (June 18, 1997).

risk-measurement techniques. Managements relying on third parties for market-risk-measurement systems and analyses should ensure that they fully understand the assumptions and techniques used.

Institutions should provide reports to their boards on the market-risk exposures of their investments on a regular basis. To do so, the institution may report the market-risk exposure of the whole institution. Alternatively, reports should contain evaluations that assess trends in aggregate market-risk exposure and the performance of portfolios in terms of established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Institutions should have mechanisms to detect and adequately address exceptions to limits and guidelines. Management reports on market risk should appropriately address potential exposures to yield curve changes and other factors pertinent to the institution's holdings.

2126.1.1.5.2 Credit Risk

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. For many financial institutions, credit risk in the investment portfolio may be low relative to other areas, such as lending. However, this risk, as with any other risk, should be effectively identified, measured, monitored, and controlled.

An institution should not acquire investments or enter into derivative contracts without assessing the creditworthiness of the issuer or counterparty. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution as comprehensively as practicable. Institutions are legally required to meet certain quality standards (i.e., investment grade) for security purchases. Many institutions maintain and update ratings reports from one of the major rating services. For nonrated securities, institutions should establish guidelines to ensure that the securities meet legal requirements and that the institution fully understands the risk involved. Institutions should establish limits on individual counterparty exposures. Policies should also provide credit-risk and concentration limits. Such limits may define concentrations relating to a single or related issuer or counterparty, a geographical area, or obligations with similar characteristics.

In managing credit risk, institutions should consider settlement and presettlement credit risk. These risks are the possibility that a counterparty will fail to honor its obligation at or before the time of settlement. The selection of dealers, investment bankers, and brokers is particularly important in effectively managing these risks. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. This includes review of information from state or federal securities regulators and industry self-regulatory organizations such as the National Association of Securities Dealers concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel.

The board of directors is responsible for supervision and oversight of investment portfolio and end-user derivatives activities, including the approval and periodic review of policies that govern relationships with securities dealers.

Sound credit-risk management requires that credit limits be developed by personnel who are as independent as practicable of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution and with the organization's overall policies and consolidated exposures.

2126.1.1.5.3 Liquidity Risk

Liquidity risk is the risk that an institution cannot easily sell, unwind, or offset a particular position at a fair price because of inadequate market depth. In specifying permissible instruments for accomplishing established objectives, institutions should ensure that they take into account the liquidity of the market for those instruments and the effect that such characteristics have on achieving their objectives. The liquidity of certain types of instruments may make them inappropriate for certain objectives. Institutions should ensure that they consider the effects that market risk can have on the liquidity of different types of instruments under various scenarios. Accordingly, institutions should articulate clearly the liquidity characteristics of instruments to be used in accomplishing institutional objectives.

Complex and illiquid instruments can often involve greater risk than actively traded, more liquid securities. Oftentimes, this higher potential risk arising from illiquidity is not captured

by standardized financial modeling techniques. Such risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for such instruments can evaporate, decreasing the market value of the instrument below the modeled value.

2126.1.1.5.4 Operational (Transaction) Risk

Operational (transaction) risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Sources of operating risk include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in investment activities.

Effective internal controls are the first line of defense in controlling the operating risks involved in an institution's investment activities. Of particular importance are internal controls that ensure the separation of duties and supervision of persons executing transactions from those responsible for processing contracts, confirming transactions, controlling various clearing accounts, preparing or posting the accounting entries, approving the accounting methodology or entries, and performing revaluations.

Consistent with the operational support of other activities within the financial institution, securities operations should be as independent as practicable from business units. Adequate resources should be devoted, such that systems and capacity are commensurate with the size and complexity of the institution's investment activities. Effective risk management should also include, at least, the following:

1. *Valuation.* Procedures should ensure independent portfolio pricing. For thinly traded or illiquid securities, completely independent pricing may be difficult to obtain. In such cases, operational units may need to use prices provided by the portfolio manager. For unique instruments where the pricing isbeing provided by a single source (e.g., the dealer providing the instrument), the institution should review and understand the assumptions used to price the instrument.
2. *Personnel.* The increasingly complex nature of securities available in the marketplace makes it important that operational personnel have strong technical skills. This will enable them to better understand the complex financial structures of some investment instruments.
3. *Documentation.* Institutions should clearly define documentation requirements for securities transactions, saving and safeguarding important documents, as well as maintaining possession and control of instruments purchased.

An institution's policies should also provide guidelines for conflicts of interest for employees who are directly involved in purchasing and selling securities for the institution from securities dealers. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with these same securities firms without specific prior board approval. The board may also wish to adopt a policy applicable to directors, officers, and employees restricting or prohibiting the receipt of gifts, gratuities, or travel expenses from approved securities dealer firms and their representatives.

2126.1.1.5.5 Legal Risk

Legal risk is the risk that contracts are not legally enforceable or documented correctly. Institutions should adequately evaluate the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has authority to enter into the transaction and that the terms of the agreement are legally enforceable. Institutions should further ascertain that netting agreements are adequately documented, executed properly, and are enforceable in all relevant jurisdictions. Institutions should have knowledge of relevant tax laws and interpretations governing the use of these instruments.

Bank holding companies should directly manage and control their aggregate risk exposures on a consolidated basis and, if appropriate, for individual subsidiaries, in view of the distinct legal existence of various subsidiaries and possible obstacles to moving cash, other assets, and contractual agreements among subsidiaries.[1] See SR-99-3.

2126.3.1 FUNDAMENTAL ELEMENTS OF COUNTERPARTY CREDIT RISK MANAGEMENT

When conducting bank holding company inspections and supervisory contacts, and when monitoring trading and derivatives activities, supervisors and examiners should fully evaluate the integrity of certain key elements of a banking organization's (BO) counterparty credit risk management process, such as the following:

1. The BO's assessment of counterparty creditworthiness, both initially and on an ongoing basis. A counterparty's creditworthiness can be evidenced by its capital strength, leverage, any on- and off-balance-sheet risk factors, and contingencies. Creditworthiness can also be evidenced by the counterparty's liquidity, operating results, reputation, and ability to understand and manage the risks inherent in its line of business, as well as the risks involved in the particular products and transactions that define a particular customer relationship.
2. The standards, methodologies, and techniques used in measuring counterparty-credit-risk exposures on an individual instrument, counterparty, and portfolio basis.
3. The use and management of credit enhancements to mitigate counterparty credit risks, including collateral arrangements and collateral-management systems, contractual downgrades or material-change triggers, and contractual "option-to-terminate" or close-out provisions.
4. The risk-limit and -monitoring systems that involve (1) setting meaningful limits on counterparty credit risk, (2) monitoring exposures against those limits, and (3) initiating meaningful risk assessments and risk-controlling actions in the event that exposures exceed limits.

The confluence of competitive pressures, pursuit of earnings, and overreliance on customer reputation can lead to substantive lapses in fundamental risk-management principles regarding counterparty risk assessment, exposure monitoring, and the management of credit-risk limits. Policies governing these activities may be unduly general so as to compromise their usefulness in managing the risks involved with particular types of counterparties. Practices may not conform to the stated policies or their intent. Situations may also exist where internal controls, including documentation and independent review, may be inadequate or lack rigor. For some larger BOs, regimes for measuring and monitoring counterparty-credit-risk exposure may be effective in more traditional areas of credit extension, but may need enhancements when used in trading and derivatives activities.

2126.3.2 TARGETING SUPERVISORY RESOURCES

When risk focusing their supervisory initiatives, examiners should continue to target those activities and areas with significant growth and above-normal profitability profiles—especially in trading and derivatives activities where the press of business and competitive pressures may invite a BO to offer new product lines before the approval of counterparties and the necessary risk-management infrastructure or procedures are fully in place. Supervisors and examiners should encourage a BO to adopt growth, profitability, and size criteria for their audit and independent risk-management functions to use in targeting their reviews.

2126.3.3 ASSESSMENT OF COUNTERPARTY CREDITWORTHINESS

Supervisors and examiners should increase their

1. These basic principles are also to be employed in the supervision of U.S. branches and agencies of foreign banks, with appropriate adaptations to reflect that (1) those offices are an integral part of a foreign bank that should be managing its risks on a consolidated basis and recognizing possible obstacles to cash movements among branches, and (2) the foreign bank is subject to overall supervision by its home-country authorities.

focus on the appropriateness, specificity, and rigor of the policies, procedures, and internal controls that a BO currently uses to assess the counterparty credit risks arising from its trading and derivatives activities. BOs should have extensive written policies covering their assessment of counterparty creditworthiness for both the initial due-diligence process (that is, before conducting business with a customer) and for ongoing monitoring. Examiners should focus particular attention on how such policies are structured and implemented. Broadly structured, general policies that apply to all types of counterparties may prove inadequate for directing staff in the proper review of the risks posed by particular types of counterparties. For example, although most policies call for the assessment and monitoring of the capital strength and leverage of customers, the assessment of hedge-fund counterparties should not rely exclusively on simple balance-sheet measures and traditional assessments of financial condition. This information may be insufficient for those counterparties whose off-balance-sheet positions are a source of significant leverage and whose risk profiles are narrowly based on concentrated business lines (such as with hedge funds and similar institutional investors). General policies calling for periodic counterparty credit reviews over significant intervals (such as annually) are another example of broad policies that may compromise the integrity of the assessment of individual counterparties or types of counterparties—a counterparty's risk profile can change significantly over much shorter time horizons.

Credit-risk-assessment policies should also properly define the types of analyses to be conducted for particular types of counterparties based on the nature of their risk profiles. Stress testing and scenario analysis may be needed, in addition to customizing fundamental analyses based on industry and business-line characteristics. Customized analyses are particularly important when a counterparty's creditworthiness may be adversely affected by short-term fluctuations in financial markets, especially when potential credit exposure to a counterparty increases at the same time the counterparty's credit quality deteriorates.

Examiners should continue to pay special attention to areas where banking organization practices may not conform to stated policies. Such supervisory efforts may be especially difficult when the BO's policies are not specificic enough for it to properly focus its counterparty risk assessments. Therefore, examiners must ensure that the banking organization's policies sufficiently address the risk profiles of particular types of counterparties and instruments. The policies should specify (1) the types of counterparties that may require special consideration; (2) the types and frequency of information to be obtained from such counterparties; (3) the types and frequency of analyses to be conducted, including the need for and type of any stress-testing analysis; and (4) how such information and analyses appropriately address the risk profile of the particular type of counterparty. This specificity in credit-assessment policies is particularly important when limited transparency may hinder market discipline on the risk-taking activities of counterparties—as may be the case with hedge funds.

Examiners should also place increasing emphasis on ensuring that a BO's existing practice conforms both with its stated objectives and the intent of its established policies. For example, some BOs may not obtain and evaluate all the information on the financial strength, condition, and liquidity of some types of counterparties that may be required by their own policies. In highly competitive and fast-moving transaction areas, organizations should be sufficiently rigorous in conducting the analyses specified in their policies, such as the review of a counterparty's ability to manage the risks of its business.

Necessary internal controls for ensuring that practices conform with stated policies include actively enforced documentation standards and periodic independent reviews by internal auditors or other risk-control units, particularly for business lines, products, and exposures to particular groups of counterparties and individual customers that exhibit significant growth or above-normal profitability. Using targeted inspections and reviews, examiners should evaluate the integrity of a BO's internal controls. Examiners should thus conduct their own transaction testing of such situations. This testing should include robust sampling of transactions with major counterparties in the targeted area, as well as sufficient stratification to ensure that practices involving smaller relationships also adhere to stated policies.

2126.3.4 CREDIT-RISK-EXPOSURE MEASUREMENT

Financial market turbulence emphasizes the important interrelationships between market

movements and the credit-risk exposures involved in derivatives activities. Accordingly, supervisors and examiners should be alert to situations where a BO may need to be more diligent in conducting current computations of the loan equivalents and potential future exposures (PFE) that are used to measure, monitor, and control its derivatives counterparty credit exposure.

Most BOs fully recognize that the credit risk of derivatives positions includes both the current replacement cost of a contract as well as the contract's PFE. PFEs are generally calculated using statistical techniques to estimate the worst potential loss over a specified time horizon at some specified confidence interval (for example, 95 percent, 97.5 percent, and 99 percent), which is generally derived in some manner from historically observed market fluctuations. Together with the current replacement cost, such PFEs are used to convert derivatives contracts to "loan equivalents" for aggregating credit exposures across products and instruments.

The time horizon used to calculate PFEs can vary depending on the banking organization's risk tolerance, collateral protection, and ability to terminate its credit exposure. Some BOs may use a time horizon equal to the life of the respective instrument. While such a time horizon may be appropriate for unsecured positions, for collateralized exposures, the use of lifetime, worst-case-estimate PFEs may be ineffective to measure the true nature of counterparty risk exposure. While life-of-contract PFE measures provide an objective and conservative long-term exposure estimate, they bear little relationship to the actual credit exposures typically incurred in the case of collateralized relationships. In such cases, a banking organization's actual credit exposure is the PFE from the time a counterparty fails to meet a collateral call until the time the bank liquidates its collateral and closes out the derivative contract—a period which is typically much shorter than the contract's life. The lack of realism in conservative measurement can cause managers and traders to discount them and may result in inappropriate limits being set, thereby compromising the entire risk-management process.

More realistic measures of collateralized credit-risk exposures should also take into account the shorter time horizons over which action can be taken to mitigate losses in times of market stress. These measures should incorporate estimates of collateral-recovery rates given the potential market liquidity impacts of stress events on collateral values. Some BOs already do stress tests, calculating measures that assess the worst-case value of positions over a time horizon of one or two weeks—their estimate of a reasonable liquidation period in times of stress. They also perform scenario analyses of counterparty credit exposures. Stress testing and scenario analyses should evaluate the impact of large market moves on the credit exposure to individual counterparties, and they should assess the implications inherent in liquidating positions under such conditions. Analyses should consider the effects of market liquidity on the value of positions and any related collateral. The use of meaningful scenario analyses is particularly important since stress tests derived from simple applications of higher confidence intervals or longer time horizons to PFE, value-at-risk, and other measures may not adequately capture the market and exposure dynamics under turbulent market conditions, particularly as they relate to the interaction between market, credit, and liquidity risk.

The results of stress testing and scenario analyses should be incorporated into senior management reports. Such reports should provide sufficient information to ensure an adequate understanding of the nature of the exposure and the analyses conducted. Information should also be sufficient to trigger risk-controlling actions where necessary.

Other BOs are moving to build the capability of estimating portfolio-based PFEs by any one of several different time horizons or buckets, depending on the liquidity and breadth of the underlying instrument or risk factor. Based on management's opinion of the appropriate workout timeframe, different time horizons can be used for different counterparties, transactions, or collateral types to more precisely define exposures. Supervisors and examiners should be alert to situations where collateralized exposures may be inaccurately estimated, and should encourage management at these BOs to enhance their exposure-measurement systems accordingly.

Supervisors should also be cognizant of the manner in which the credit exposures are aggregated for individual counterparties. Some BOs may take a purely transactional approach to aggregation and *not incorporate the netting of long and short derivatives contracts*, even when legally enforceable bilateral netting agreements are available. In such cases, *simple sum estimates of positive exposures may seriously overestimate true credit exposure*, and examiners should monitor and encourage a BO's movement toward more realistic measures of counter-

party exposure. Other BOs may take a portfolio approach, in which information systems allow and incorporate netting (both within and across products, business lines, or risk factors) and portfolio correlation effects to construct more comprehensive counterparty exposure measures. In such cases, supervisors should ensure that a BO has adequate internal controls governing exposure estimation, including robust model-review processes and data-integrity checks.

When stratifying samples and selecting the counterparties and transactions to use for their targeted testing of practices and internal controls, supervisors and examiners should incorporate measures of potential future exposure regardless of the collateralization of current market-value exposures. As recent events have shown, meaningful counterparty credit risks that surface during periods of stress can go undetected when too much emphasis is placed on collateralization of current market values and only unsecured current market exposures are used for targeting transaction testing.

2126.3.5 CREDIT ENHANCEMENTS

BOs continue to rely increasingly on different types of credit enhancements to mitigate counterparty credit risks. These enhancements include the use of collateral arrangements, contractual downgrades or material-change triggers that enable the alteration of collateral or margining arrangements, or the activation of contractual "option to terminate" or closeout provisions.

CollateraIization of exposures has become an industry standard for many types of counterparties. Collateralization mitigates but does not eliminate credit risks. BOs therefore should ensure that overreliance on collateral does not compromise other elements of sound counterparty credit-risk management, such as the due-diligence process. Clear policies should govern the determination of loss thresholds and margining requirements for derivatives counterparties of BOs. Such policies should not be so broad that they compromise the risk-reducing nature of collateral agreements with specific types of counterparties. Policies governing collateral arrangements should specifically define those cases in which initial and variation margin is required, and they should explicitly identify situations in which the lack of transparency, business-line risk profiles, and other counterparty characteristics merit special treatment—as may be the case with some highly leveraged counterparties such as hedge funds. Where consistent with the risk profile of the counterparty and instruments involved, policies should specify when margining requirements based on estimates of potential future exposures might be warranted.

Adequate policies should also govern the use of material-change triggers and closeout provisions, which should take into account counterparty-specific situations and risk profiles. For example, closeout provisions based on annual events or material-change triggers based on long-term performance may prove ineffective for counterparties whose risk profiles can change rapidly. Also, such material-change triggers, closeout provisions, and related covenants should be designed to adequately protect against deterioration in a counterparty's creditworthiness. They should ensure that a BO is made aware of adverse financial developments on a timely basis and should facilitate action as counterparty risk increases—well in advance of the time when termination of a relationship is appropriate.

Internal assessments of potential risk exposures sometimes dictate loss thresholds, margining requirements, and closeout provisions with some counterparties. Insufficient internal controls may unduly expose certain BOs to these as well as other types of trading and derivatives counterparties. When evaluating the management of collateral arrangements and other credit enhancements, examiners should not only assess the adequacy of a banking organization's policies but should also determine whether internal controls are sufficient to ensure that practices comply with these policies. Examiners should identify the types of credit enhancements and contractual covenants that are being used when reviewing areas of counterparty risk management, and then determine whether the banking organization has sufficiently assessed the adequacy of these enhancements and covenants relative to the risk profile of the counterparty.

2126.3.6 CREDIT-RISK-EXPOSURE LIMIT-SETTING AND MONITORING SYSTEMS

Exposure-monitoring and limit systems are critical to the effective management of counterparty credit risk. Examiners should focus special attention on the policies, practices, and internal controls employed within such systems at large, complex BOs. An effective exposure-

monitoring system consists of (1) establishing meaningful limits on the risk exposures a BO is willing to take, (2) independent, ongoing monitoring of exposures against such limits, and (3) adequate controls to ensure that meaningful risk-controlling action takes place when limits are exceeded. An effective exposure-monitoring and limit process depends on meaningful exposure-measurement methodologies, so supervisors should closely evaluate measurement methodologies, especially for the estimation of PFEs. Inaccurate measurement can easily compromise well-structured policies and procedures. Such situations can lead to limits driven primarily by customer demand and used only to define and monitor customer facilities, rather than limits that serve as strict levels defined by credit management and that initiate risk-controlling actions.

Supervisors and examiners should also assess the procedures used for controlling credit-risk exposures when they become large, when a counterparty's credit standing weakens, or when the market comes under stress. Management should demonstrate its clear ability to reduce large positions. Such actions can include ''capping'' current exposures, curtailing new business, assigning transactions to another counterparty (where feasible), and restructuring the transaction to limit potential exposure or make it less sensitive to market volatility. BOs can also use various credit-enhancement tools to manage exposures that have become unduly large or highly sensitive to market volatility.

2126.3.7 INSPECTION OBJECTIVES

1. To determine if sufficient resources are devoted and adequate attention is given to the management of the risks involved in growing, highly profitable, or potentially high-risk activities and product lines.
2. To ascertain if the banking organization's internal audit and independent risk-management functions adequately focus on growth, profitability, and risk criteria when targeting their reviews.
3. To determine if there is an appropriate balance among all elements of credit-risk management. This balance includes both qualitative and quantitative assessments of counterparty creditworthiness; measurement and evaluation of on- and off-balance sheet exposures, including potential future exposure; adequate stress testing; reliance on collateral and other credit enhancements; and the monitoring of exposures against meaningful limits.
4. To ascertain whether the banking organization employs policies that are sufficiently calibrated to the risk profiles of particular types of counterparties and instruments, which ensures adequate credit-risk assessment, exposure measurement, limit setting, and use of credit enhancements.
5. To ensure that the banking organization's actual business practices conform with their stated policies and the intent of these policies.
6. To establish if the banking organization is moving in a timely fashion to enhance its measurement of counterparty credit-risk exposures, including refining potential future exposure measures and establishing stress-testing methodologies to better incorporate the interaction of market and credit risks.
7. To accomplish the above inspection objectives by using sufficient, targeted transaction testing on those activities, business lines, and products experiencing significant growth, above-normal profitability, or large potential future exposures.

2126.3.8 INSPECTION PROCEDURES

1. Give increased focus to the adequacy, appropriateness, specificity, and rigor of the policies, procedures, and internal controls that a BO currently uses to assess the counterparty credit risks arising from its trading and derivatives activities.
   a. Determine if sufficient written policies cover the assessment of counterparty creditworthiness for the initial due-diligence process (that is, before conducting business with a customer) and for ongoing monitoring.
   b. Give particular attention to how such policies are structured, their adequacy, and how they are implemented.
2. Focus special attention on areas where a BO's practices may not conform to its stated policies.
   a. Determine if the banking organization's policies sufficiently address the risk profiles of its particular types of counterparties and instruments.
   b. Ascertain whether existing practices conform to the stated objectives and the intent of the organization's established policies.

3. Evaluate the banking organization's documentation standards.
4. Determine whether the internal reviews are adequately conducted for business lines, products, and exposures to particular groups of counterparties and individual customers that exhibit significant growth or above-normal profitability.
5. Evaluate the integrity of the internal controls that the banking organization uses to assess its own transaction testing during internal reviews.
6. Conduct independent targeted reviews of the internal controls.
   a. Use robust sampling when testing transactions of major counterparties within a targeted area.
   b. Employ sufficient stratification to ensure that practices involving smaller relationships also adhere to stated policies.
   c. Be alert to situations whereby the current computations of loan equivalents and potential exposures—that are used to measure, monitor, and control derivatives counterparty credit exposures—could be deliberately enhanced.
7. Determine if the banking organization needs to develop more meaningful measures of credit-risk exposures, such as using stress testing and scenario analyses, under volatile market conditions.

Interest-Rate Risk (Risk Management and Internal Controls) Section 2127.0

Interest-rate risk (IRR) is the exposure of a banking organization's financial condition to adverse movements in interest rates. Accepting this risk can be an important source of profitability and shareholder value. However, excessive levels of IRR can pose a significant threat to a bank's or bank holding company's earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the organization's safety and soundness.

Evaluating a bank holding company's exposure to changes in interest rates is an important element of any full-scope inspection and may be the sole topic for specialized or targeted inspections. This evaluation includes assessing both the adequacy of the management process used to control IRR and the organization's quantitative level of exposure. When assessing the IRR management process, examiners should ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain IRR at prudent levels with consistency and continuity. Evaluating the quantitative level of IRR exposure requires examiners to assess the existing and potential future effects of changes in interest rates on a bank holding company's consolidated financial condition, including its capital adequacy; earnings; liquidity; and, where appropriate, asset quality. To ensure that these assessments are both effective and efficient, examiner resources must be appropriately targeted at those elements of an organization's IRR that pose the greatest threat to its financial condition. This targeting requires an inspection process built on a well-focused assessment of IRR exposure before the on-site engagement, a clearly defined inspection scope, and a comprehensive program for following up on inspection findings and ongoing monitoring.

The Board, together with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, adopted a Joint Agency Policy Statement on Interest-Rate Risk, effective June 26, 1996. (See SR-96-17.) It provides guidance to examiners and bankers on sound practices for managing interest-rate risk, which will form the basis for ongoing evaluation of the adequacy of interest-rate risk management at supervised institutions.

The policy statement outlines fundamental elements of sound management that have been identified in prior Federal Reserve guidance and discusses the importance of these elements in the context of managing interest-rate risk.[1] Specifically, the guidance emphasizes the need for active board and senior management oversight and a comprehensive risk-management process that effectively identifies, measures, and controls interest-rate risk.

Although the guidance targets interest-rate risk management at commercial banks and Edge Act corporations, the basic principles presented in the policy statement are to be applied to bank holding companies. Bank holding companies should manage and control aggregate risk exposure on a consolidated basis by recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. The assessment of interest-rate risk management made by examiners in accordance with the 1996 Joint Policy Statement will be incorporated into a bank holding company's overall risk-management rating. Bank holding company examiners should refer to section 4090.1 of the *Commercial Bank Examination Manual* for more detailed inspection guidance on the joint policy statement on interest-rate risk.

1. Guidance to examiners identifying fundamental elements of sound risk management includes SR-96-14 (see section 2124.0), "Risk-Focused Examinations and Inspections"; SR-96-13, "Joint Policy Statement on Interest-Rate Risk"; SR-96-10, "Risk-Focused Fiduciary Examinations"; SR-95-51 (see section 4070.1), "Rating the Adequacy of Risk-Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"; SR-95-22, "Enhanced Framework for Supervising the U.S. Operations of Foreign Banking Organizations"; SR-95-17 (see section 2126.0), "Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities"; and SR-93-69 (see section 2125.0), "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations."

Structured Notes (Risk Management and Internal Controls) Section 2128.0

This section discusses supervisory policy with regard to structured notes and their increased use by banking organizations. Examiners should be mindful of these instruments, whether they are used in the banking organization's trading, investment, or trust activities. Some of these instruments can expose investors to significant losses as interest rates, foreign-exchange rates, and other market indices change. Consequently, during examinations/inspections, examiners need to ensure that banks and bank holding companies that hold structured notes do so according to their own investment policies and procedures and with a full understanding of the risks and price sensitivity of these instruments under a broad range of market conditions.

Structured notes, many of which are issued by U.S. government agencies, government-sponsored entities, and other organizations with high credit ratings, are debt securities whose cash flows are dependent on one or more indices in ways that create risk characteristics of forwards or options. They tend to have medium-term maturities and reflect a wide variety of cash-flow characteristics that can be tailored to the needs of individual investors.

As such, these notes may offer certain advantages over other financial instruments used to manage market risk. In particular, they may reduce counterparty credit risk, offer operating efficiencies and lower transaction costs, require fewer transactions, and more specifically address an institution's risk exposures. Risk to principal is typically small. Accordingly, when structured notes are analyzed and managed properly, they can be acceptable investments and trading products for banks.

However, structured notes can also have characteristics that cause them to be inappropriate holdings for many banking organizations, including depository institutions. They can have substantial price sensitivity; they can be complex and difficult to evaluate; and they may also reflect high amounts of leverage relative to fixed-income instruments with comparable face values. Their customized features and embedded options may also make them difficult to price and can reduce their liquidity. Consequently, banking organizations considering the purchase of structured notes should determine whether these factors are compatible with their investment horizons and with their overall portfolio strategies.

There are a wide variety of structured notes, with names such as single- or multi-index floaters, inverse floaters, index-amortizing notes, step-up bonds, and range bonds. These simple, though sometimes cryptic, labels can belie the potential complexity of these notes and their possibly volatile and unpredictable cash flows, which can involve both principal and interest payments. Some notes employ "trigger levels" at which cash flows can change significantly, or caps or floors, which can also substantially affect their price behavior.

The critical factor for examiners to consider is the ability of management to understand the risks inherent in these instruments and to satisfactorily manage the market risks of their institution. Therefore, examiners should evaluate the appropriateness of these securities institution by institution, with a knowledge of management's expertise in evaluating such instruments, the quality of the relevant information systems, and the nature of its overall exposure to market risk. This evaluation may include a review of the stress-test capabilities. Failure of management to adequately understand the dimensions of the risks in these and similar financial products can constitute an unsafe and unsound practice for banking organizations.

When making investment decisions, some banking organizations may focus only on the low credit risk and favorable yields of structured notes and either overlook or underestimate their market and liquidity risks. Consequently, where these notes are material, examiners should discuss their role in the organization's risk-management process and assess management's recognition of their potential volatility.

The risks inherent in such complex instruments and relevant risk-management standards have been addressed in a variety of previously issued supervisory guidance, including SR-letters and supervisory manuals. They include SR-90-16 (see also section 2190.0), which provides standards for investing in asset-backed securities; SR-93-69 (see section 2125.0) and SR-95-17 for securities and derivative contracts used in nontrading activities, which advise examiners when reviewing trading and nontrading activities; and the *Trading and Capital-Markets Activities Manual*. Although these documents may not specifically cite structured notes, they all help to highlight the following important supervisory and risk-management practices that are relevant to these instruments:

1. the importance of board of directors approved policies that address the goals and objectives expected to be achieved with such products and that set limits on the amount of funds that may be committed to them
2. the need for management to fully understand the risks these instruments can present, including their potentially reduced liquidity in secondary markets and the price volatility that any embedded options, leveraging, or other characteristics can create
3. the need for adequate information systems and internal controls for managing the risks under changing market conditions
4. the importance of clear lines of authority for making investment decisions and for evaluating and managing the institution's securities activities that involve such instruments

For additional information, see SR-97-21, SR-95-17, and SR-91-4. See also section 2126.0 and sections 3010.3 and 4040.1 of the *Trading and Capital-Markets Activities Manual* for more detailed guidance.

Securitization activities present unique and sometimes complex risks that require the attention of senior management and the board of directors. Retained interests from securitization activities, including interest-only strips receivable, arise when a banking organization (BO) keeps an interest in the assets sold to a securitization vehicle that, in turn, issues bonds to investors.[1]

The methods and models BOs use to value retained interests and the difficulties in managing exposure to these volatile assets can raise supervisory concerns. Under generally accepted accounting principles (GAAP), a BO recognizes an immediate gain (or loss) on the sale of assets by recording its retained interest at fair value. The valuation of the retained interest is based on the present value of future cash flows in excess of the amounts needed to service the bonds and cover credit losses and other fees of the securitization vehicle.[2]

Determinations of fair value should be based on reasonable, conservative assumptions about factors such as discount rates, projected credit losses, and prepayment rates. Bank supervisors expect retained interests to be supported by verifiable documentation of fair value in accordance with GAAP. In the absence of such support, the retained interests should not be carried as assets on a BO's books, but should be charged off. Other supervisory concerns include failure to recognize and hold sufficient capital against recourse obligations generated by securitizations, and the absence of an adequate independent audit function.

The supervisory guidance focuses on and incorporates important fundamental concepts of risk-management and risk-focused supervision: active oversight by senior management and the board of directors, the use of effective policies and limits, accurate and independent procedures to measure and assess risk, and the maintenance of strong internal controls.[3] The guidance stresses sound risk-management, modeling, valuation, and disclosure practices for asset securitization; complements previous supervisory guidance issued on this subject; and supplements existing policy statements and examination-inspection procedures.[4] Emphasis is placed on the expectation that a BO's securitization-related retained interest must be supported by documentation of the interest's fair value, using reasonable, conservative valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support or that fail to meet these supervisory standards will be classified as loss and disallowed for inclusion as assets of the BO for regulatory capital purposes. See SR-99-37 and the more complete text of its referenced interagency guidance on the risk mangement and valuation of retained interests arising from asset securitization activities.

Examiners will review a BO's valuation of retained interests and the concentration of these assets relative to capital. Consistent with existing supervisory authority, BOs may be required, on a case-by-case basis, to hold additional capital commensurate with their risk exposures.[5] An excessive dependence on securitizations for day-to-day core funding can present significant liquidity problems during times of market turbulence or if there are difficulties specific to the BO.

2128.06.1 ASSET SECURITIZATION

Asset securitization typically involves the transfer of on-balance-sheet assets to a third party or trust. In turn, the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. BOs use asset securi-

1. The term "banking organization" (BO) refers to any federally supervised banking organization. This includes federally insured, federally chartered financial institutions that are supervised by a federal bank or savings association supervisory authority, as well as bank holding companies and their nonbank subsidiaries.

2. See Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard No. 125 (FAS 125), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities."

3. See SR-96-14, "Risk-Focused Safety-and-Soundness Examinations and Inspections" (section 2124.0 of this manual), and SR-95-51, "Rating the Adequacy of Risk-Management Processes and Internal Controls at State Member Banks and Bank Holding Companies" (section 4070.1 of this manual).

4. See SR-97-21, "Risk Management and Capital Adequacy of Exposures Arising from Secondary-Market Credit Activities"; SR-96-40, "Interim Guidance for Purposes of Applying FAS 125 for Regulatory Reporting in 1997 and for the Treatment of Servicing Assets for Regulatory Capital"; and SR-96-30, "Risk-Based Capital Treatment for Spread Accounts That Provide Credit Enhancement for Securitized Receivables."

5. For instance, a BO has high concentrations of retained interests relative to its capital or is otherwise at risk from impairment of these assets.

tization to access alternative funding sources, manage concentrations, improve financial-performance ratios, and more efficiently meet customer needs. Assets typically securitized include credit card receivables, automobile receivable paper, commercial and residential first mortgages, commercial loans, home equity loans, and student loans.

Senior management and directors must have the requisite knowledge of the effect of securitization on the BO's risk profile and must be fully aware of the accounting, legal, and risk-based capital nuances of this activity. BOs must fully and accurately distinguish and measure the risks that are transferred versus those retained, and must adequately manage the retained portion. It is essential that BOs engaging in securitization activities have appropriate front- and back-office staffing, internal and external accounting and legal support, audit or independent review coverage, information systems capacity, and oversight mechanisms to execute, record, and administer these transactions correctly.

Appropriate valuation and modeling methodologies must be used. They must be able to determine the initial and ongoing value of retained interests. Accounting rules provide a method to recognize an immediate gain (or loss) on the sale through booking a ''retained interest.'' The carrying value, however, of that interest must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent impairment in value. The best evidence of fair value is a quoted market price in an active market. When quoted market prices are not available, accounting rules allow fair value to be estimated. This estimate must be based on the ''best information available in the circumstances.''[6] An estimate of fair value must be supported by reasonable and current assumptions. If a best estimate of fair value is not practicable, the asset is to be recorded at zero in financial and regulatory reports.

Unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, a BO that securitizes assets may inappropriately generate ''paper profits'' or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements; substantial write-downs of retained interests; and, if retained interests represent an excessive concentration of the sponsoring BO's capital, the BO's demise. BO managers and directors need to ensure the following:

1. Independent risk-management processes are in place to monitor securitization-pool performance on an aggregate and individual transaction level. An effective risk-management function includes appropriate information systems to monitor securitization activities.
2. Conservative valuation assumptions and modeling methodologies are used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
3. Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets the BO retains. The findings of such reviews should be reported directly to the board or an appropriate board committee.
4. Accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity.
5. Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.
6. A realistic liquidity plan is in place for the BO in case of market disruptions.

2128.06.2 INDEPENDENT RISK-MANAGEMENT FUNCTION

BOs engaged in securitizations should have an independent risk-management function commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk-management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the BO's circumstances. A sound asset securitization policy should include or address, at a minimum—

1. a writtten and consistently applied accounting methodology;
2. regulatory reporting requirements;
3. valuation methods, including FAS 125 residual value assumptions, and procedures

6. See FAS 125, at para. 43.

to formally approve changes to those assumptions;
4. a management reporting process; and
5. exposure limits and requirements for both aggregate and individual transaction monitoring.

It is essential that the risk-management function monitor origination, collection, and default-management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default-management staff to resolve severely delinquent loans in a timely and efficient manner, and the appropriateness of loss-recognition practices. Because the securitization of assets can result in the current recognition of *anticipated income*, the risk-management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred, and serviced. Senior management and the risk-management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher-risk assets to sustain ongoing income needs. Such pressures can lead to a compromise of credit-underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests, and potentially lead to funding problems.

The risk-management function should also ensure that appropriate management information systems (MIS) exist to monitor securitization activities. Reporting and documentation methods must support the initial valuation of retained interests and ongoing impairment analyses of these assets. Pool-performance information will help well-managed BOs ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions. The absence of quality MIS will hinder management's ability to monitor specific pool performance and securitization activities.

At a minimum, MIS reports should address the following:

1. *Securitization summaries for each transaction.* The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit-enhancement and subordination features, financial covenants (termination events and spread-account capture "triggers"), right of repurchase, and counterparty exposures. Management should ensure that the summaries for each transaction are distributed to all personnel associated with securitization activities.
2. *Performance reports by portfolio and specific product type.* Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments or payments, and excess spread amounts. The reports should reflect the performance of assets, both on an individual-pool basis and total managed assets. These reports should segregate specific products and different marketing campaigns.
3. *Vintage analysis for each pool using monthly data.* Vintage analysis will help management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore retained interest values. Management can use these reports to compare historical performance trends with underwriting standards, including the use of a validated credit-scoring model, to ensure loan pricing is consistent with risk levels. Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained-interest valuation assumptions.
4. *Static-pool cash-collection analysis.* A static-pool cash-collection analysis involves reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. Management should compare monthly the timing and amount of cash flows received from the trust with those projected as part of the FAS 125 retained-interest valuation analysis. Some master-trust structures allow excess cash flow to be shared between series or pools. For revolving-asset trusts with this master-trust structure, management should perform a cash-collection analysis for each master-trust structure. These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the retained interest.
5. *Sensitivity analysis.* A sensitivity analysis measures the effect of changes in default rates, prepayment or payment rates, and dis-

count rates to assist management in establishing and validating the carrying value of the retained interest. Stress tests should be performed at least quarterly. Analyses should consider potential adverse trends and determine "best," "probable," and "worst case" scenarios for each event. Other factors that need to be considered are the impact of increased defaults on collections staffing, the timing of cash flows, spread-account capture triggers, overcollateralization triggers, and early-amortization triggers. An increase in defaults can result in higher than expected costs and a delay in cash flows, thus decreasing the value of the retained interests. Management should periodically quantify and document the potential impact to both earnings and capital, and report the results to the board of directors. Management should incorporate this analysis into their overall interest-rate risk measurement system.[7] Examiners will review the BO-conducted analysis and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating (the "S" in the CAMELS rating system for banks or the "M" for the BHC rating system[8]).

6. *Statement of covenant compliance.* Ongoing compliance with deal-performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to overcollateralization requirements, and events that would result in servicer removal.

2128.06.3 VALUATION AND MODELING PROCESSES

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment or payment rates, default rates, loss-severity factors, and discount rates. BOs are expected to take a logical and conservative approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions at least quarterly on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving-asset trusts if the master-trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master-trust level.

To determine the value of the retained interest at inception, and make appropriate adjustments going forward, the BO must implement a reasonable modeling process to comply with FAS 125. Management is expected to employ reasonable and conservative valuation assumptions and projections, and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring that the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or overcollateralization triggers, trust fees, and insurance payments if appropriate. The board and management are accountable for the model builders' possessing the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of MIS associated with securitization activities.

As part of the modeling process, the risk-management function should ensure that periodic validations are performed to reduce vulnerability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models using actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure the validation process is independent from line management and from the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the BO's circumstances and executed consistent with its asset securitization policy.

7. The Joint Agency Policy Statement on Interest-Rate Risk (see SR-96-13 and section 2127.0) advises institutions with a high level of exposure to interest-rate risk relative to capital that they will be directed to take corrective action.
8. See sections 4070.0 and 4070.1.

2128.06.4 USE OF OUTSIDE PARTIES

Third parties are often engaged to provide professional guidance and support regarding a BO's securitization activities, transactions, and valuing of retained interests. The use of outside resources does not relieve directors of their oversight responsibility, or relieve senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, particularly the management of the risks associated with retained interests. Management is expected to have the experience, knowledge, and abilities to discharge its duties and understand the nature and extent of the risks retained interests present, and to have the policies and procedures necessary to implement an effective risk-management system to control such risks. Management must have a full understanding of the valuation techniques employed, including the basis and reasonableness of underlying assumptions and projections.

2128.06.5 INTERNAL CONTROLS

Effective internal controls are essential to a BO's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the BO's resources; ensure that financial information and reports are reliable; and comply with contractual obligations, including securitization covenants. It will also reduce the possibility of significant errors and irregularities, and assist in their timely detection. Internal controls typically (1) limit authorities; (2) safeguard access to and use of records; (3) separate and rotate duties; and (4) ensure both regular and unscheduled reviews, including testing.

Operational and managerial standards have been established for internal control and information systems.[9] A system of internal controls should be maintained that is appropriate to the BO's size and the nature, scope, and risk of its activities.[10]

2128.06.6 AUDIT FUNCTION OR INTERNAL REVIEW

A BO's board of directors is responsible for ensuring that its audit staff or independent review function is competent regarding securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures (FAS 125), deal covenants, and the accuracy of MIS and regulatory reports. The audit function also should confirm that the BO's regulatory reporting process is designed and managed to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure that balances reconcile to internal records.

2128.06.7 REGULATORY REPORTING OF RETAINED INTERESTS

The securitization and subsequent removal of assets from a BO's balance sheet requires additional reporting as part of the regulatoryreporting process. Common regulatory reporting errors stemming from securitization activities may include—

1. failure to include off-balance-sheet assets subject to recourse treatment when calculating risk-based capital ratios;
2. failure to recognize retained interests and retained subordinate security interests as a form of credit enhancement;
3. failure to report loans sold with recourse in the appropriate section of the regulatory report; and
4. overvaluing retained interests.

A BO's directors and senior management are responsible for the accuracy of its regulatory

9. See the safety-and-soundness standards for national banks at 12 CFR 30 (OCC), and for savings associations at 12 CFR 570 (OTS).

10. BOs that are subject to the requirements of FDIC regulation 12 CFR 363 should include an assessment of the effectiveness of internal controls over their asset securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes the internal controls over financial information that is included in regulatory reports.

reports. Because of the complexities associated with securitization accounting and risk-based capital treatment, attention should be directed to ensuring that personnel who prepare these reports maintain current knowledge of reporting rules and associated interpretations. This often will require ongoing support by qualified accounting and legal personnel.

2128.06.8 MARKET DISCIPLINE AND DISCLOSURES

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory efforts to promote high standards in risk management. Timely and adequate information on the BO's asset securitization activities should be disclosed. The information in the disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and complexity of the BO. Well-informed investors, depositors, creditors, and other counterparties can provide a BO with strong incentives for maintaining sound risk-management systems and internal controls. Adequate disclosure allows market participants to better understand the BO's financial condition and apply market discipline, creating incentives to reduce inappropriate risk taking or inadequate risk-management practices. Examples of sound disclosures include—

1. accounting policies for measuring retained interests, including a discussion of the impact of key assumptions on the recorded value;
2. the process and methodology used to adjust the value of retained interests for changes in key assumptions;
3. risk characteristics, both quantitative and qualitative, of the underlying securitized assets;
4. the role of retained interests as credit enhancements to special-purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and
5. sensitivity analyses or stress testing conducted by the BO, showing the effect of changes in key assumptions on the fair value of retained interests.

2128.06.9 RISK-BASED CAPITAL FOR RECOURSE AND LOW-LEVEL-RECOURSE TRANSACTIONS

For regulatory purposes, recourse is generally defined as an arrangement in which an institution retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of its claim on the assets.[11] In addition to broad contractual language that may require the seller to support a securitization, recourse can arise from retained interests, retained subordinated security interests, the funding of cash-collateral accounts, or other forms of credit enhancements that place a BO's earnings and capital at risk. These enhancements should generally be *aggregated* to determine the extent of a BO's support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

Securitization transactions involving recourse may be eligible for "low-level-recourse" treatment.[12] Risk-based capital standards provide that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a BO is contractually liable. The low-level-recourse treatment applies to transactions accounted for as sales under GAAP in which a BO contractually limits its recourse exposure to less than the full risk-based capital requirements for the assets transferred. Under the low-level-recourse principle, the BO holds capital on approximately a dollar-for-dollar basis up to the amount of the aggregate credit enhancements.

If a BO does not contractually limit the maximum amount of its recourse obligation, or if the amount of credit enhancement is greater than the risk-based capital requirement that would exist if the assets were not sold, the low-level-recourse treatment does not apply. Instead, the

11. See the risk-based capital treatment for sales with recourse at 12 CFR 3, appendix A, section (3)(b)(1)(iii) (OCC), and 12 CFR 567.6(a)(2)(i)(c) (OTS). For a further explanation of recourse, see the glossary of the call report instructions, "Sales of Assets for Risk-Based Capital Purposes."

12. See 60 *Fed. Reg.* 17986, April 10, 1995 (OCC); 60 *Fed. Reg.* 8177, February 13, 1995 (FRB); and 60 *Fed. Reg.* 15858, March 28,1995 (FDIC). The OTS low-level-recourse rule is found at 12 CFR 567.6(a)(2)(i)(c).

BO must hold risk-based capital against the securitized assets as if those assets had not been sold. Retained interests that lack objectively verifiable support or that fail to meet the supervisory standards set forth in this section will be classified as loss and disallowed as assets of the BO for regulatory capital purposes.

2128.06.10 CONCENTRATION LIMITS IMPOSED ON RETAINED INTERESTS

The creation of a retained interest (the debit) typically also results in an offsetting "gain on sale" (the credit), and thus generation of an asset. BOs that securitize high-yielding assets with long durations may create a retained-interest asset value that exceeds the risk-based capital charge that would be in place if it had not sold the assets (under the existing risk-based capital guidelines, capital is not required for the amount over 8 percent of the securitized assets). Serious problems can arise for those BOs that distribute contrived earnings only later to be faced with a downward valuation and charge-off of part or all of the retained interests.

As an example, a BO could sell $100 in subprime home equity loans and book a retained interest of $20 using liberal "gain on sale" assumptions. Under the current capital rules, the BO is required to hold approximately $8 in capital. This $8 is the current capital requirement if the loans were never removed from the balance sheet (8 percent of $100 = $8). However, the institution is still exposed to substantially all the credit risk, plus the additional risk to earnings and capital from the volatility of the retained interest. If the value of the retained interest decreases to $10 due to inaccurate assumptions or changes in market conditions, the $8 in capital is insufficient to cover the entire loss.

Normally, the sponsor will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. However, recent experience has shown that retained interests are vulnerable to sudden and sizeable write-downs that can hinder a BO's access to the capital markets; damage its reputation in the marketplace; and, in some cases, threaten its solvency. A BO's board of directors and management is expected to develop and implement policies that limit the amount of retained interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well-constructed internal limits also lessen the incentives for a BO's personnel to engage in activities designed to generate near-term "paper profits" that may be at the expense of its long-term financial position and reputation.

2128.06.11 INSPECTION OBJECTIVES

1. To determine whether the BO's retained interests from asset securitization are properly documented, valued, and accounted for.
2. To verify that the amount of those retained interests not supported by adequate documentation has been charged off and that the involved assets are not used for risk-based calculation purposes.
3. To ascertain the existence of sound risk modeling, management information systems (MIS), and disclosure practices for asset securitization.
4. To obtain assurances that the board of directors and management oversee sound policies and internal controls concerning the recording and valuation of retained interests derived from asset securitization activities.
5. To determine if liquidity problems may arise as the result of an overdependence on asset securitization activities for day-to-day core funding.
6. To determine that sufficient capital is held commensurate with the risk exposures arising from recourse obligations generated by asset securitizations.
7. To determine whether there is an independent audit function that is capable of evaluating retained interests involving asset securitization activities.

2128.06.12 INSPECTION PROCEDURES

1. Determine the existence of independent risk-management processes and MIS, and whether they are being used to monitor securitization-pool performance on an aggregate and individual transaction level.
2. Review the MIS reports and determine whether the reports provide—
   a. securitization summaries for each transaction;
   b. performance reports by portfolio and specific product type;
   c. vintage analysis for each pool using monthly data;

d. static-pool cash-collection analysis;
e. sensitivity analysis; and
f. a statement of covenant compliance.

3. Review the BO's valuation assumptions and modeling methodologies, and determine if they are conservative and being used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
4. Determine if audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets that the BO retains.
5. Review the risk-based capital calculations, and determine if they include recognition and reporting of any recourse obligation resulting from securitization activities.
6. Ascertain that internal limits govern the amount of retained interests held as a percentage of total equity capital.
7. Establish that an adequate liquidity contingency plan is in place and that it will be used in the event of market disruptions. Determine further whether liquidity problems may arise as the result of an overdependence on asset securitization activities for day-to-day core funding.
8. Determine whether consistent, conservative accounting practices are in place that satisfy the reporting requirements of regulatory supervisors, GAAP reporting requirements, and valuation assumptions and methods. Ascertain that adequate disclosures of asset securitization activities are made commensurate with the volume of securitizations and the complexities of the BO.
9. Establish that risk-exposure limits and requirements exist and are adhered to on an aggregate and individual transaction basis.

Banking organizations must establish and maintain sound risk-management policies and procedures and effective internal controls over their use of credit derivatives. Credit derivatives are off-balance-sheet financial instruments that are used to assume or lay off credit risk on loans and other assets, some only to a limited extent. They allow one party (the beneficiary) to transfer the credit risk of a ''reference asset,'' which it often actually owns, to another party (the guarantor).[1] This arrangement allows the guarantor party to assume the credit risk associated with the reference asset without directly purchasing it. Unlike traditional guarantee arrangements, credit-derivative transactions often are documented using master agreements developed by the International Swaps and Derivatives Association (ISDA) that are similar to those governing swaps or options. Since credit derivatives are privately negotiated financial contracts, they expose the user to credit risk as well as liquidity risk (thin secondary market for credit derivatives), operational risk (instruments used for speculation rather than hedging), counterparty risk (default), and legal risk (the contracts may be deemed illegal).

Banking organizations use credit-derivative instruments either as end-users, purchasing credit protection from or providing credit protection to third parties, or as dealers intermediating such protection. Credit derivatives are used to manage overall credit-risk exposure. A banking organization may use credit derivatives to mitigate its concentration to a particular borrower or industry without severing the customer relationship. In addition, organizations that are approaching established in-house limits on counterparty credit exposure could continue to originate loans to a particular industry, using credit derivatives to transfer the credit risk to a third party.

Banking organizations may also use credit derivatives to diversify their portfolios by assuming the associated credit exposures and revenue returns to different borrowers or industries without actually purchasing the underlying assets. Nonbank companies may serve as counterparties to credit-derivative transactions with banks to gain access to the commercial bank loan market. Such entities may not lend or may not have the facilities or staff to adequately administer a loan portfolio.

Under some credit-derivative arrangements, a beneficiary may pay a fee to the guarantor in exchange for a guarantee against any loss that may occur, usually in excess of a prespecified amount, if the reference asset defaults (a ''credit-default swap''). Alternatively, the beneficiary may pay the total return on a reference asset, including any appreciation in the asset's price, to a guarantor in exchange for a spread over funding costs plus any depreciation in the value of the reference asset (a ''total-rate-of-return swap'').

Credit derivatives and their market are likely to take on various forms, such as the market for put options on specific corporate bonds or loans. While the payoffs of these puts are expressed in terms of a strike price, rather than a default event, if the strike price is sufficiently high, credit risk effectively could be transferred from the buyer of the put to the writer of the put. See SR-96-17.

2129.0.1 SUPERVISORY AND EXAMINER GUIDANCE

In reviewing credit derivatives, examiners should consider the credit risk associated with the reference asset as the primary risk, as they do for loan participations or guarantees. A banking organization providing credit protection through a credit derivative may be as exposed to the credit risk of the reference asset as it would be if the asset were on its own balance sheet. Thus, for supervisory purposes, the exposure generally should be treated as if it were a letter of credit or other off-balance-sheet guarantee.[2] This treatment would apply, for example, in determining a banking organization's overall credit exposure to a borrower for purposes of evaluating concentrations of credit. The overall exposure should include exposure it assumes

1. For purposes of this supervisory guidance, when the beneficiary owns the reference asset, it will be referred to as the ''underlying'' asset. However, in some cases, the reference asset and the underlying asset are not the same. For example, the credit-derivative contract may reference the performance of an ABC Company bond, while the beneficiary banking organization may actually own an ABC Company loan. The use of the term ''guarantor'' does not necessarily refer to a guarantor involving a suretyship contract. The transferred risk can be in a primary liability of the acquiring party that assumes the credit risk.

2. Credit derivatives that are based on a broad-based index, such as the Lehman Brothers Bond Index or the S&P 500 stock index, could be treated for capital and other supervisory purposes as a derivative contract. This determination should be made on a case-by-case basis.

by acting as a guarantor in a credit-derivative transaction where the borrower is the obligor of the reference asset.

Banking organizations providing credit protection through a credit derivative should hold capital and reserves against their exposure to the reference asset.[3] This broad principle holds for all credit derivatives, except for credit-derivative contracts that incorporate periodic payments for depreciation or appreciation, including most total-rate-of-return swaps. For these transactions, the guarantor can deduct the amount of depreciation paid to the beneficiary from the notional amount of the contract in determining the amount of reference exposure subject to a capital charge.

In some cases (for example, total-rate-of-return swaps), the guarantor also is exposed to the credit risk of the counterparty, which for derivative contracts generally is measured as the replacement cost of the credit-derivative transaction plus an add-on for the potential future exposure of the derivative to market price changes. For banking organizations acting as dealers that have matching offsetting positions, the counterparty risk stemming from credit-derivative transactions could be the principal risk to which the dealer banks are exposed.

In reviewing a credit derivative entered into by a beneficiary banking organization, the examiner should review the organization's credit exposure to the guarantor, as well as to the reference asset—if the asset is actually owned by the beneficiary. The degree to which a credit derivative, unlike most other credit-guarantee arrangements, transfers the credit risk of an underlying asset from the beneficiary to the guarantor may be uncertain or limited. The degree of risk transference depends on the terms of the transaction. For example, some credit derivatives are structured so that a payout only occurs when a predefined event of default or a downgrade below a prespecified credit rating occurs.[4] Others may require a payment only when a defined default event occurs *and* a predetermined materiality (or loss) threshold is exceeded. Default payments themselves may be based on an average of dealer prices for the reference asset during some period of time after default using a prespecified sampling procedure or may be specified in advance as a set percentage of the notional amount of the reference asset. Finally, the term of many credit-derivative transactions is shorter than the maturity of the underlying asset and, thus, provides only temporary credit protection to the beneficiary.

Examiners must ascertain whether the amount of credit protection a beneficiary receives by entering into a credit derivative is sufficient to warrant treatment of the derivative as a guarantee for regulatory capital and other supervisory purposes. Those arrangements that provide virtually complete credit protection to the underlying asset will be considered effective guarantees for purposes of asset classification and risk-based capital calculations. On the other hand, if the amount of credit risk transferred by the beneficiary is severely limited or uncertain, then the limited credit protection provided by the derivative should not be taken into account for these purposes.

In this regard, examiners should carefully review credit-derivative transactions in which the reference asset is not identical to the asset actually owned by the beneficiary banking organization. For the derivative contract to be considered as providing effective credit protection, the examiner must review the arrangement and be satisfied that the reference asset is an appropriate proxy for the loan or other asset, whose credit exposure the banking organization intends to offset. To determine this, examiners should consider, among other factors, whether the reference asset and owned asset have the same obligor and seniority in bankruptcy and whether both contain mutual cross-default provisions.

A banking organization's management should not enter into credit-derivative transactions unless it has the ability to understand and manage the credit and other risks associated with these instruments in a safe and sound manner. Accordingly, examiners should determine the appropriateness of these instruments on an entity-by-entity basis, taking into account management's expertise in evaluating the instruments used; the adequacy of relevant policies, including position limits; and the quality of the banking organization's relevant information systems and internal controls.[5]

3. For guidance on risk-based capital treatment of credit derivatives, see section 4060.3.5.3.9.

4. It may also be necessary to review the credit documentation of the primary obligor to determine the degree of transferred risk.

5. For further guidance on examining the risk-management practices of banking organizations, including guidance on derivatives, that examiners may find helpful in reviewing an organization's management of its credit-derivative activity, see sections 2125.0, 2126.0, 2128.0, and 4070.1. See also the *Commercial Bank Examination Manual* and the *Trading and Capital-Markets Activities Manual*.

2129.0.2 TYPES OF CREDIT DERIVATIVES

The most widely used types of credit derivatives are credit-default swaps and total-rate-of-return (TROR) swaps.[6] While the timing and structure of the cash flows associated with credit default and TROR swaps differ, the economic substance of both arrangements is that they seek to transfer the credit risk on the asset(s) referenced in the transaction.

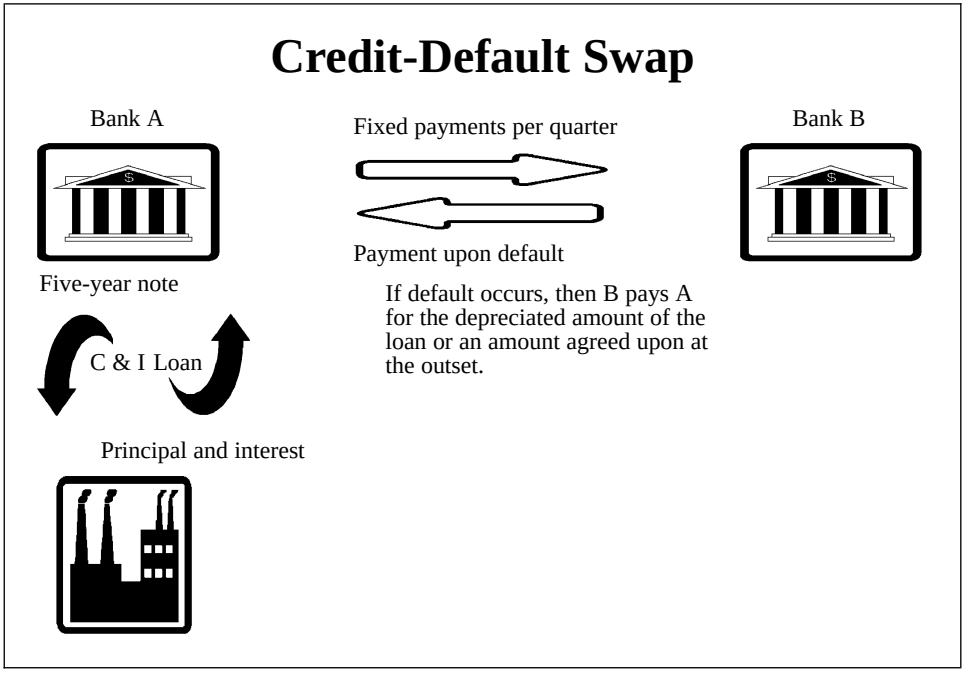
6. Another less common form of credit derivative is the *credit-linked note*, which is an obligation that is based on a reference asset. Credit-linked notes are similar to structured notes with embedded credit derivatives. If there is a credit event, the repayment of the bond's principal is based on the price of the reference asset. A credit-linked note may be a combination of a regular bond and a credit option. The note can promise to make periodic interest payments and a large lump-sum payment when the bond matures. The credit option on the note may allow the issuer to reduce the note's payments if a primary financial indicator or variable deteriorates. When reviewing these transactions, examiners should consider the purchasing banking organization's exposure to the underlying reference asset as well as the exposure to the issuing entity.

2129.0.2.1 Credit-Default Swaps

The purpose of a credit-default swap is to provide protection against credit losses associated with a default on a specified reference asset. The swap purchaser (the beneficiary) "swaps" the credit risk with the provider of the swap (the guarantor). The transaction is very similar to a guarantee or financial standby letter of credit.

In a credit-default swap, illustrated in figure 1, the beneficiary (Bank A) agrees to pay to the guarantor (Bank B) a quarterly or annual fee, typically amounting to a certain number of basis points on the par value of the reference asset. In return, the guarantor agrees to pay the beneficiary an agreed-upon, market-based, post-default amount or a predetermined fixed percentage of the value of the reference asset if there is a default. The guarantor makes no payment until there is a default. A default is strictly defined in the contract to include, for example, bankruptcy, insolvency, or payment default, and the event of default itself must be publicly verifiable. The guarantor may not be obliged to

Figure 1
Credit-Default Swap Cash-Flow Diagram



make any payments to the beneficiary until a preestablished amount of loss has been exceeded in conjunction with a default event (called a materiality threshold).

The swap is terminated if the reference asset defaults before the maturity of the swap. The amount owed by the guarantor is the difference between the reference asset's initial principal (or notional) amount and the actual market value of the defaulted, reference asset. The methodology for establishing the post-default market value of the reference asset should be set out in the contract. Often, the market value of the defaulted reference asset may be determined by sampling dealer quotes. The guarantor may have the option to purchase the defaulted, underlying asset and pursue a workout with the borrower directly, an action it may take if it believes that the "true" value of the reference asset is higher than that determined by the swap-pricing mechanism. Alternatively, the swap may call for a fixed payment in the event of default, such as a percentage of the notional value of the reference asset.

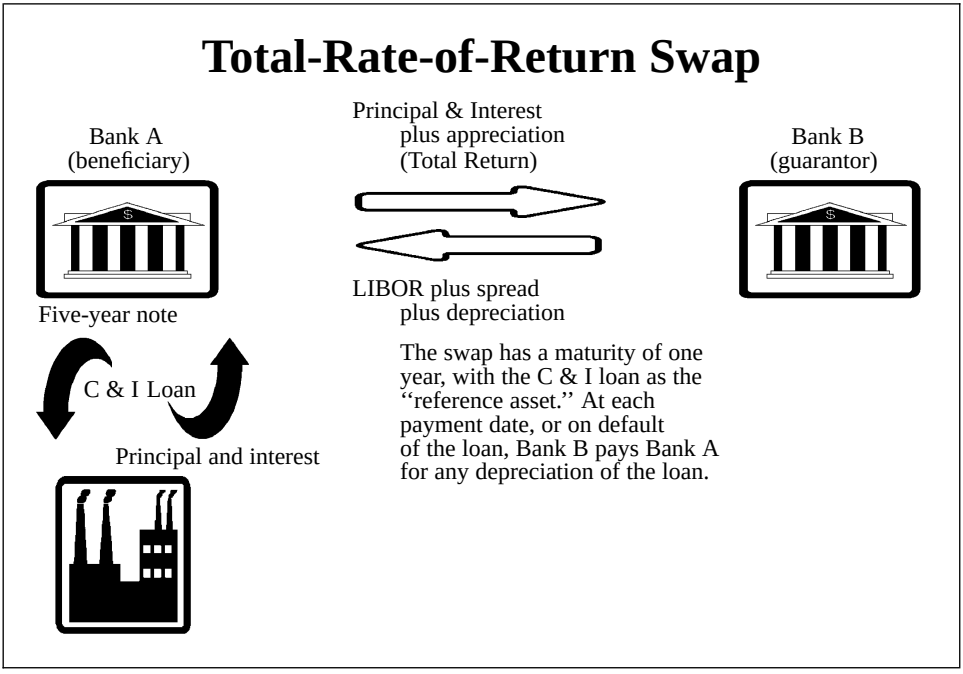
2129.0.2.2 Total-Rate-of-Return Swaps

In a total-rate-of-return (TROR) swap, illustrated in figure 2, the beneficiary (Bank A) agrees to pay the guarantor (Bank B) the "total return" on the reference asset, which consists of all contractual payments, as well as any appreciation in the market value of the reference asset. To complete the swap arrangement, the guarantor agrees to pay LIBOR plus a spread and any depreciation to the beneficiary.[7] Since it bears the risks and rewards of ownership over the term of the swap, the guarantor in a TROR swap could be viewed as having synthetic ownership of the reference asset.

At each payment-exchange date (including when the swap matures) or on default, at which-point the swap may terminate, any depreciation

7. The reference asset is often a floating-rate instrument, for example, a prime-based loan. Thus, if both sides of a TROR swap are based on floating rates, interest-rate risk is effectively eliminated with the exception of some basis risk.

Figure 2
Total-Rate-of-Return Swap Cash-Flow Diagram



or appreciation in the amortized value of the reference asset is calculated as the difference between the notional principal balance of the reference asset and the "dealer price."[8] The dealer price is generally determined either by referring to a market quotation source or by polling a group of dealers, and the price reflects changes in the credit profile of the reference obligor and reference asset.

If the dealer price is less than the notional amount of the contract (the hypothetical original price of the reference asset), then the guarantor must pay the difference to the beneficiary, absorbing any loss caused by a decline in the credit quality of the reference asset.[9] Thus, a TROR swap differs from a standard direct credit substitute in that the guarantor is guaranteeing not only against default of the reference obligor, but also against a deterioration in that obligor's credit quality, which can occur even if there is no default.

TROR swaps allow banking organizations to diversify credit risk and at the same time maintain confidentiality of their client's financial records since the borrowing entity's financial records are held by the originating lender. When the loans are sold, the records are transferred to the new acquiring lender. TROR swaps generally involve fewer administrative costs than those involved in a loan-sales transaction. Risk diversification can thus be achieved at a reduced cost.

2129.0.3 OTHER SUPERVISORY ISSUES

The decision to treat credit derivatives as guarantees could have significant supervisory implications for the way examiners treat concentration risk, classified assets, the adequacy of the allowance for loan and lease losses (ALLL),[10] and transactions involving affiliates. Examples of how credit derivatives that effectively transfer credit risk could affect supervisory procedures are discussed below.

2129.0.3.1 Credit Exposure

For internal purposes of managing credit risk, banking organizations are encouraged to develop policies to determine how credit-derivative activity will be used to manage credit exposures. For example, a banking organization's internal credit policies may set forth situations in which it is appropriate to reduce credit exposure to an underlying obligor through credit-derivative transactions. Such policies need to address when credit exposure is effectively reduced and how all credit exposures will be monitored, including those resulting from credit-derivative activities.

2129.0.3.2 Concentrations of Credit

Concentrations of credit may be defined as—

- loans collateralized by a common security;
- loans to one borrower or related group of borrowers;
- loans that depend on a particular agricultural commodity;
- aggregate loans to major employers, their employees, and their major suppliers;
- loans within industry groups;
- out-of-territory loans;
- the aggregate amount of paper purchased from any one source; or
- those loans that often have been included in other homogeneous risk groupings.

Credit concentrations, by their nature, depend on common key factors, and when weaknesses develop, they have an adverse impact on each individual loan making up the concentration.[11] Generally, examiners should not consider a banking organization's asset concentration to a particular borrower reduced because of the existence of a nongovernment guarantee on one of the borrower's loans since the underlying concentration to the borrower still exists. However, examiners should consider how the banking organization manages the concentration, which could include the use of nongovernmental guarantees. Asset concentrations are to be listed in the confidential "Administrative and Other Matters" page D of the inspection report to highlight that the ultimate risk to the banking organization stems from these concentrations,

8. Depending on contract terms, a TROR swap may not terminate on default of the reference asset. Instead, payments would continue to be made on subsequent payment dates based on the reference asset's post-default prices until the swap's contractual maturity.

9. As in a credit-default swap, the guarantor may have the option of purchasing the underlying asset from the beneficiary at the dealer price and trying to collect from the borrower directly.

10. See sections 2010.7 and 2065.2.

11. See sections 2010.2, 2010.7, and 2065.2.

although the associated credit risk may be mitigated by the existence of nongovernmental guarantees.

Any nongovernment guarantee will be included with other exposures to the guarantor to determine if there is an asset concentration with respect to the guarantor. Thus, the use of credit derivatives will increase the beneficiary's concentration exposure to the guarantor without reducing the concentration risk of the underlying borrower. Similarly, a guarantor banking organization's exposure to all reference assets will be included in its overall credit exposure to the reference obligor.

2129.0.3.3 Classification of Assets

The criteria used to classify assets are primarily based on their degree of risk and the likelihood of repayment, as well as on the potential effect of the assets on the bank's safety and soundness.[12] When evaluating the quality of a loan, examiners should review the overall financial condition of the borrower; the borrower's credit history; any secondary sources of repayment, such as guarantees; and other factors. The primary focus in the review of a loan's quality is the original source of payment. The assessment of the credit quality of a troubled loan, however, should take into account support provided by a "financially responsible guarantor."[13]

The protection that a credit derivative from a financially responsible guarantor provides on an underlying asset may be sufficient to preclude classification of the underlying asset or reduce the severity of classification. Sufficiency *depends on the extent of credit protection that is provided*. To be considered a guarantee for purposes of determining the classification of assets, a credit derivative must transfer the credit risk from the beneficiary to the financially responsible guarantor; the financially responsible guarantor must have *both* the financial capacity and willingness to provide support for the credit; the guarantee (the credit-derivative contract) must be legally enforceable; and the guarantee must provide support for repayment of the indebtedness, in whole or in part, during the remaining term of the underlying asset.

However, credit derivatives tend to have a shorter maturity than the underlying asset being protected. Furthermore, it is uncertain whether the credit derivative will be renewed once it matures. Thus, when determining whether to classify an underlying asset protected by a credit derivative, examiners need to consider the *term* of the credit derivative in relation to the maturity of the protected underlying asset, the probability that the protected underlying asset will default while the guarantee is in force, and whether the credit risk has actually been transferred. In general, the beneficiary banking organization continues to be exposed to the credit risk of the classified underlying asset when the maturity of the credit derivative is shorter than the underlying asset. Thus, in these situations of maturity mismatch, the examiner's presumption may be against a diminution of the severity of the underlying asset's classification.

For guarantor banking organizations, examiners should review the credit quality of individual reference assets in derivative contracts in the same manner as other credit instruments, such as standby letters of credit. Thus, examiners should evaluate a credit derivative in which a banking organization provides credit protection based on the overall financial condition and resources of the reference obligor; the obligor's credit history; and any secondary sources of repayment, such as collateral. As a rule, exposure from providing credit protection through a credit derivative should be classified if the reference asset is classified.[14]

2129.0.3.4 Transactions Involving Affiliates

Credit-derivative transactions can involve two or more legal entities (affiliates) within the same banking organization. Thus, transactions between or involving affiliates raise important supervisory issues, especially whether such arrangements are effective guarantees of affiliate obligations or transfers of assets and their related credit exposure between affiliates. Banking organizations should carefully consider existing supervisory guidance on interaffiliate

12. Loans that exhibit potential weaknesses are categorized as "substandard," while those with well-defined weaknesses and a distinct possibility of loss are either "doubtful" or "loss."

13. See section 5010.10 of this manual and section 2060.1 of the *Commercial Bank Examination Manual*.

14. A guarantor banking organization providing credit protection through the use of a credit derivative on a classified asset of a beneficiary bank may preclude classification of *its derivative contract* by laying off the risk exposure to another financially responsible guarantor. This could be accomplished through the use of a second offsetting credit-derivative transaction.

transactions before entering into credit-derivative arrangements involving affiliates, particularly when substantially the same objectives could be met using traditional guarantee instruments.

2129.0.4 INSPECTION OBJECTIVES

1. To determine if the banking organization is providing credit protection through a credit derivative.
2. To ascertain whether the banking organization has and maintains sound risk-management policies and procedures and effective internal controls over the use of credit derivatives.
3. To review and evaluate existing risk involving credit-derivative arrangements.
4. To ascertain whether adequate capital and reserves are held against exposures to reference assets, including whether risk-based capital computations have accounted for any additional risk resulting from derivative arrangements.

2129.0.5 INSPECTION PROCEDURES

1. Consider credit risk associated with reference assets as primary risks. Determine whether the credit-risk exposure is treated as if it was a letter of credit or other off-balance-sheet guarantee.
2. Review the organization's credit exposure to the guarantor, as well as to the reference asset. Determine if the asset is actually owned by the beneficiary.
3. Ascertain whether the amount of credit protection a beneficiary receives when entering into a credit derivative is sufficient to warrant treatment of the derivative as a guarantee for regulatory capital and other supervisory purposes.
4. Review credit-derivative transactions in which the reference asset is not identical to the asset actually owned by the beneficiary banking organization.
   a. Ascertain if the reference asset is an appropriate proxy for loans or other assets whose credit exposure the banking organization intends to offset.
   b. Consider whether the reference asset and owned asset have the same obligor and seniority in bankruptcy and whether both contain mutual cross-default provisions.
5. Determine whether management has the ability to understand and manage the credit and other risks associated with credit derivatives in a safe and sound manner. Consider management's expertise in evaluating the instruments; the adequacy of relevant policies, including position limits; and the quality of the banking organization's relevant management information systems and internal controls.
6. Evaluate the management of a banking organization's asset concentration to a particular borrower, which could include the use of non-governmental guarantees on one or more of the borrower's loans. List the asset concentrations in the confidential "Administrative and Other Matters'' page D of the inspection report.
7. Review the quality of loans and the overall financial condition of the borrower; the borrower's credit history; any secondary sources of repayment, such as financially responsible guarantors; and other factors.
8. When determining whether to classify an underlying asset protected by a credit derivative, compare the *term* of the credit derivative in relation to the maturity of the protected underlying asset, the probability that the protected underlying asset will default while the guarantee is in force, and whether the credit risk has actually been transferred.
9. For guarantor banking organizations, review the credit quality of individual reference assets in derivative contracts in the same manner as other credit instruments, such as standby letters of credit.
   a. Evaluate a credit derivative in which a banking organization provides credit protection based on the overall financial condition and resources of the reference obligor; the obligor's credit history; and any secondary sources of repayment, such as collateral.
   b. If the reference asset is classified, classify the exposure from providing credit protection through a credit derivative.

Banking organizations have substantially increased their secondary-market credit activities such as loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. These activities can enhance both credit availability and bank profitability, but managing the risks of these activities poses increasing challenges. This is because the risks involved, while not new to banking, may be less obvious and more complex than the risks of traditional lending activities. Some secondary-market credit activities involve credit, liquidity, operational, legal, and reputational risks in concentrations and forms that may not be fully recognized by bank management or adequately incorporated in an institution's risk-management systems. In reviewing these activities, supervisors[1] and examiners should assess whether banking organizations fully understand and adequately manage the full range of the risks involved in secondary-market credit activities.

The heightened need for management attention to these risks is underscored by reports from examiners, surveys of senior lending officers, and discussions with trade and advisory groups. They have indicated that competitive conditions over the past few years have encouraged an easing of credit terms and conditions in both commercial and consumer lending. In addition, indications are that some potential participants in loan syndications have found it necessary to make complex credit decisions within a much shorter timeframe than has been customary. Although the recent easing may not be imprudent, the incentives and pressures to lower credit standards have increased as competition has intensified and borrowers have experienced generally favorable business and economic conditions. Supervisors and bank management alike should remain alert to the possibility that loan performance could deteriorate if certain sectors of the economy experience problems. The recent rise in consumer bankruptcies, credit card delinquencies, and credit charge-offs illustrates this concern. These types of developments could have significant implications for the risks associated with secondary-market credit activities.

This section identifies some of the important risks involved in several of the more common types of secondary-market credit activities. Guidance is provided on sound practices along with special considerations supervisors should take into account in assessing the risk-management systems for these activities. A banking institution's failure to understand adequately the risks inherent in secondary-market credit activities and the failure to incorporate for such risk within its risk-management systems and internal capital allocations may constitute an unsafe and unsound banking practice.

A fundamental principle is advanced in this guidance: Banking institutions should explicitly incorporate the full range of risks of their secondary-market credit activities into their overall risk-management systems.[2] In particular, supervisors and examiners should determine whether institutions are recognizing the risks of secondary-market credit activities by (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the board of directors and in regulatory reports; (3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. Incorporating secondary-market credit activities into banking organizations' risk-management systems and internal capital adequacy allocations is particularly important. This guidance builds on, supports, and is fully consistent with existing guidance on risk management issued by the Federal Reserve.[3]

1. The term "supervisors" is intended to refer to Federal Reserve System staff.

2. This guidance applies to the secondary-market credit activities conducted by state member banks, bank holding companies, Edge corporations, and U.S. branches and agencies of foreign banks. For this guidance, secondary-market credit activities include, but are not limited to, loan syndications; loan participations; loan sales and purchases; credit derivatives; asset securitization; and both implied and direct credit enhancements that may support these or the related activities of the institution, its affiliates, or third parties. Asset securitization activities refer to the issuance, underwriting, and servicing of asset-backed securities; the provision of credit or liquidity enhancements to securitized transactions; and investment in asset-backed securities.

3. For a more detailed discussion of risk management, see SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"; SR-95-17, "Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities"; SR-93-69, "Risk Management and Internal Controls for Trading Activities of Banking Organizations"; and SR-90-16, "Implementation of

Improvements in technology, greater standardization of lending products, and the use of credit enhancements have helped to increase dramatically the volume of loan syndications, loan sales, loan participations, asset securitizations, and credit guarantees undertaken by commercial banks, affiliates of bank holding companies, and some U.S. branches and agencies of foreign banks. In addition, the advent of credit derivatives permits banking organizations to trade credit risk, manage it in isolation from other types of risk, and maintain credit relationships while transferring the associated credit risk. Such developments have improved the availability of credit to businesses and consumers, allowed management to better tailor the mix of credit risk within loan and securities portfolios, and helped to improve overall bank profitability.

Certain credit and liquidity enhancements that banking organizations provide to facilitate various secondary-market credit activities can make the evaluation of their risks less straightforward than the risks involved in traditional on-balance-sheet banking activities. These enhancements, or guarantees, generally manifest themselves as recourse provisions, securitization structures that entail credit-linked early amortization and collateral replacement events, and direct credit substitutes such as letters of credit and subordinated interests that, in effect, provide credit support to secondary-market instruments and transactions.[4]

The transactions involving such enhancements tend to be complex and may expose the institutions extending them to hidden obligations that may not become evident until the transactions have deteriorated. In substance, such activities move the credit risk off the balance sheet by shifting risks associated with traditional on-balance-sheet assets into off-balance-sheet contingent liabilities. Given the potential complexity and, in some cases, the indirect nature of these enhancements, the actual credit-risk exposure can be difficult to assess, especially in the context of traditional credit-risk limit, measurement, and reporting systems.

Moreover, many secondary-market credit activities involve new and compounded dimensions of reputational, liquidity, operational, and legal risks that are not readily identifiable and may be difficult to control. For example, recourse provisions and certain asset-backed security structures can give rise to significant reputational and liquidity-risk exposures, and ongoing management of underlying collateral in securitization transactions can expose an institution to unique operating and legal risks.

For those institutions involved in providing credit enhancements in connection with loan sales and securitizations, and those involved in credit derivatives and loan syndications, supervisors and examiners should assess whether the institutions' systems and processes adequately identify, measure, monitor, and control *all* of the risks involved in the secondary-market credit activities. In particular, the risk-management systems employed should include the identification, measurement, and monitoring of these risks as well as an appropriate methodology for the internal allocation of capital and reserves. The stress testing conducted within the risk-measurement element of the management system should fully incorporate the risk exposures of these activities under various scenarios to identify their potential effect on an institution's liquidity, earnings, and capital adequacy. Moreover, management reports should adequately communicate to senior management and the board of directors the risks associated with these activities and the contingency plans that are in place to deal with adverse conditions. See SR-97-21.

2129.05.1 CREDIT RISKS IN SECONDARY-MARKET CREDIT ACTIVITIES

Institutions should be aware that the credit risk involved in many secondary-market credit activities may not always be obvious. For certain types of loan sales and securitization transactions, a banking organization may actually be exposed to essentially the same credit risk as in traditional lending activities, even though a particular transaction may, superficially, appear to have isolated the institution from any risk exposure. In such cases, removal of an asset from the balance sheet may not result in a commensurate

Examination Guidelines for the Review of Asset Securitization Activities."

4. Examiners should also review SR-96-30, "Risk-Based Capital Treatment for Spread Accounts that Provide Credit Enhancement for Securitized Receivables." In addition, banking organizations have retained the risk of loss, that is, recourse, on sales and securitizations of assets when, in accordance with generally accepted accounting principles, they record on their balance sheets interest-only strip receivables or other assets that serve as credit enhancements. For more information, see Statement of Financial Accounting Standards No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities," and the instructions to the Reports of Income and Condition.

reduction in credit risk. Transactions that can give rise to such instances include loan sales with recourse; credit derivatives; direct credit substitutes, such as letters of credit; and liquidity facilities extended to securitization programs, as well as certain asset securitization structures, such as the structure typically used to securitize credit card receivables.

2129.05.1.1 Loan Syndications

Recently, the underwriting standards of some syndications have been relaxed through the easing or elimination of certain covenants or the use of interest-only arrangements. Bank management should continually review syndication underwriting standards and pricing practices to ensure that they remain consistent over time with (1) the degree of risk associated with the activity and (2) the potential for unexpected economic developments to adversely affect borrower creditworthiness.

In some cases, potential participants in loan syndications have felt it necessary to make decisions to commit to the syndication within a shorter period of time than is customary. Supervisors and examiners should determine whether syndicate participants are performing their own independent credit analysis of the syndicated credit and make sure they are not placing undue reliance on the analysis of the lead underwriter or on commercial-loan credit ratings. Banking organizations should not feel pressured to make an irrevocable commitment to participate in a syndication until such an analysis is complete.

2129.05.1.2 Credit Derivatives

Credit derivatives are generally off-balance-sheet financial instruments[5] that are used by banking organizations to assume or mitigate the credit risk of loans and other assets.[6] Banking organizations are increasingly employing these instruments either as end-users, purchasing credit protection from—or providing credit protection to—third parties, or as dealers intermediating such protection. In reviewing credit derivatives, supervisors should consider the credit risk associated with the reference asset, as well as general market risk and the risk of the counterparty to the contract.

With respect to credit-derivative transactions in which banking organizations are mitigating the credit risk of their assets, supervisors and examiners should carefully review those situations in which the reference assets are not identical to the assets actually owned by the institutions. Supervisors should consider whether the reference asset is an appropriate proxy for the loan or other asset whose credit exposure the banking organization intends to offset.

2129.05.1.3 Recourse Obligations, Direct Credit Substitutes, and Liquidity Facilities

2129.05.1.3.1 Recourse Obligations

Partial, first-loss recourse obligations retained when selling assets, and the extension of partial credit enhancements (for example, 10 percent letters of credit), can be a source of concentrated credit risk by exposing institutions to the full amount of expected losses on the protected assets. For instance, the credit risk associated with whole loans or pools of assets that are sold to secondary-market investors can often be concentrated within the partial, first-loss recourse obligations retained by banking organizations selling and securitizing the assets. In these situations, even though institutions may have reduced their exposure to catastrophic loss on the assets sold, they generally retain the same credit-risk exposure as if they continued to hold the assets on their balance sheets.

2129.05.1.3.2 Direct Credit Substitutes

Institutions also assume concentrated credit risk through the extension of partial direct credit substitutes, such as the purchase of subordinated interests and the extension of letters of credit. For example, banking organizations that sponsor certain asset-backed commercial paper programs, or so-called ''remote origination'' conduits, can be exposed to high degrees of credit risk even though it may seem that their notional exposure is minimal. Such a remote origination conduit lends directly to corporate customers referred to it by the sponsoring banking organization that used to lend directly to these same borrowers. The conduit funds this lending activity by issuing commercial paper that, in turn, is

5. Credit-linked notes are on-balance-sheet instruments.

6. See SR-96-17, ''Supervisory Guidance for Credit Derivatives,'' for a discussion of supervisory issues regarding credit derivatives, including the risk-based capital treatment of credit derivatives held in the banking book. SR-97-18, ''Application of Market Risk Capital Requirements to Credit Derivatives,'' provides guidance on the risk-based capital treatment of credit derivatives held in the trading book.

guaranteed by the sponsoring banking organization. The net result is that the sponsoring institution has much the same credit-risk exposure through this guarantee as if it had made the loans directly and held them on its books. However, this credit extension is an off-balance-sheet transaction, and the associated risks may not be fully reflected in the institution's risk-management system.

2129.05.1.3.3 Liquidity Facilities

Banking organizations that extend liquidity facilities to securitized transactions, particularly asset-backed commercial paper programs, may be exposed to high degrees of credit risk which may be subtly embedded within the facilities' provisions. Liquidity facilities are commitments to extend short-term credit to cover temporary shortfalls in cash flow. While all commitments embody some degree of credit risk, certain commitments extended to asset-backed commercial paper programs to provide liquidity may subject the extending institution to the credit risk of the underlying asset pool, often trade receivables, or of a specific company using the program for funding. Often the stated purpose of such liquidity facilities is to provide funds to the program to retire maturing commercial paper when a mismatch occurs in the maturities of the underlying receivables and the commercial paper, or when a disruption occurs in the commercial paper market. However, depending on the provisions of the facility—such as whether the facility covers dilution of the underlying receivable pool—credit risk can be shifted from the program's explicit credit enhancements to the liquidity facility.[7] Such provisions may enable certain programs to fund riskier assets and yet maintain the credit rating on the program's commercial paper without increasing the program's credit enhancement levels.

2129.05.1.4 Asset Securitization Structures

The structure of various securitization transactions can result in an institution's retaining the underlying credit risk in a sold pool of assets. An example of this contingent credit-risk retention is credit card securitizations in which the securitizing organization explicitly sells the credit card receivables to a master trust but, in substance, retains the majority of the economic risk of loss associated with the assets. This is because of the credit protection provided to investors by the excess yield, spread accounts, and structural provisions of the securitization. Excess yield provides the first level of credit protection that can be drawn upon to cover cash shortfalls between the principal and coupon owed to investors and the investors' pro rata share of the master trust's net cash flows. The excess yield is equal to the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses.[8] The second level of credit protection is provided by the spread account, which is essentially a reserve funded initially from the excess yield.

The structural provisions of credit card securitizations generally provide credit protection to investors through the triggering of early amortization events. Such an event usually is triggered when the underlying pool of credit card receivables deteriorates beyond a certain point and requires that the outstanding credit card securities begin amortizing early in order to pay off investors before the prior credit enhancements are exhausted. As the early amortization accelerates the redemption of principal (pay down) on the security, the credit card accounts that were assigned to the master credit card trust return to the securitizing institution more quickly than had originally been anticipated, thus exposing the institution to liquidity pressures and any further credit losses on the returned accounts.

2129.05.2 REPUTATIONAL RISKS

The secondary-market credit activities of many institutions may expose them to significant reputational risks. Loan-syndication underwriting may present significant reputational-risk exposure to lead underwriters because syndicate participants may seek to hold the lead underwriter responsible for actual or perceived inadequacies in the loan's underwriting, even though partici-

7. Dilution essentially occurs when the receivables in the underlying asset pool—before collection—are no longer viable financial obligations of the customer. For example, dilution can arise from returns of consumer goods or unsold merchandise by retailers to manufacturers or distributors.

8. The monthly excess yield is the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses. It is calculated by subtracting from the gross portfolio yield the (1) coupon paid to investors; (2) charge-offs for that month; and (3) servicing fee, usually 200 basis points paid to the banking organization sponsoring the securitization.

pants are responsible for conducting an independent due-diligence evaluation of each credit. Such risk may be compounded by the rapid growth of new investors in this market, usually nonbanks that may not have previously endured a downturn in the loan market.

There is the possibility that pressure may be brought to bear on the lead participant to repurchase portions of the syndication if the credit deteriorates in order to protect its reputation in the market, even though the syndication was sold without recourse. In addition, the deterioration of the syndicated credit exposes the lead organization to possible litigation, as well as increased operational and credit risk. One way to mitigate reputational risk in syndications is for banking organizations to know their customers[9] and to determine whether syndication customers are in a position to conduct their own evaluation of the credit risks involved in the transaction.

Asset securitization programs also can be a source of increasing reputational risk. Often, banking organizations sponsoring the issuance of asset-backed securities act as servicer, administrator, or liquidity provider in the securitization transaction. It is imperative that these institutions are aware of the potential losses and risk exposure associated with reputational risk. The securitization of assets whose performance has deteriorated may result in a negative market reaction that could increase the spreads on an institution's subsequent issuances. In order to avoid a possible increase in their funding costs, institutions have supported their securitization transactions by improving the performance of the securitized asset pool. This has been accomplished, for example, by selling discounted receivables or adding higher-quality assets to the securitized asset pool. Thus, an institution's voluntary support of its securitization in order to protect its reputation can adversely affect the sponsoring/issuing organization's earnings and capital.

Such methods of improving the credit quality of securitized asset pools have been used by banking organizations in providing voluntary support to their securitizations, especially for credit card master trusts. These actions generally are taken to avoid either a rating downgrade or an early amortization of the outstanding asset-backed securities.

9. See the know-your-customer rules in Regulation H (12 C.F.R. 208), Regulation K (12 C.F.R. 211), and Regulation Y (12 C.F.R. 225).

2129.05.3 LIQUIDITY RISKS

The existence of recourse provisions in asset sales, the extension of liquidity facilities to securitization programs, and the early amortization triggers of certain asset securitization transactions can involve significant liquidity risk to institutions engaged in these secondary-market credit activities. Institutions should ensure that their liquidity contingency plans fully incorporate the potential risk posed by their secondary-market credit activities. With the issuance of new asset-backed securities, the issuing banking organization should determine the potential effect on its liquidity at the inception of each transaction and throughout the life of the securities to better ascertain its future funding needs.

An institution's contingency plans should consider the need to obtain replacement funding, and specify the possible alternative funding sources, in the event of the amortization of outstanding asset-backed securities. This is particularly important for securitizations with revolving receivables, such as credit cards, where an early amortization of the asset-backed securities could unexpectedly return the outstanding balances of the securitized accounts to the issuing institution's balance sheet. An early amortization of a banking organization's asset-backed securities could impede its ability to fund itself—either through re-issuance or other borrowings—since the institution's reputation with investors and lenders may be adversely affected.

2129.05.4 INCORPORATING THE RISKS OF SECONDARY-MARKET CREDIT ACTIVITIES INTO RISK MANAGEMENT

Supervisors should verify that an institution incorporates the risks involved in its secondary-market credit activities in its overall risk-management system. The system should entail (1) inclusion of risk exposures in reports to the institution's senior management and board to ensure proper management oversight; (2) adoption of appropriate policies, procedures, and guidelines to manage the risks involved; (3) appropriate measurement and monitoring of risks; and (4) assurance of appropriate internal controls to verify the integrity of the management process with respect to these activities. The formality and sophistication with which the

risks of these activities are incorporated into an institution's risk-management system should be commensurate with the nature and volume of its secondary-market credit activities. Institutions with significant activities in this area are expected to have more elaborate and formal approaches to manage the risk of their secondary-market credit activities.

2129.05.4.1 Board of Directors and Senior Management Responsibilities

Both the board of directors and senior management are responsible for ensuring that they fully understand the degree to which the organization is exposed to the credit, market, liquidity, operational, legal, and reputational risks involved in the institution's secondary-market credit activities. They are also responsible for ensuring that the formality and sophistication of the techniques used to manage these risks are commensurate with the level of the organization's activities. The board should approve all significant policies relating to the management of risk arising from secondary-market credit activities and should ensure that the risk exposures are fully incorporated in board reports and risk-management reviews.

Senior management is responsible for ensuring that the risks arising from secondary-market credit activities are adequately managed on both a short-term and long-run basis. Management should ensure that there are adequate policies and procedures in place for incorporating the risk of these activities into the overall risk-management process of the institution. Such policies should ensure that the economic substance of the risk exposures generated by these activities is fully recognized and appropriately managed. In addition, banking organizations involved in securitization activities should have appropriate policies, procedures, and controls with respect to underwriting asset-backed securities; funding the possible return of revolving receivables (for example, credit card receivables and home equity lines); and establishing limits on exposures to individual institutions, types of collateral, and geographic and industrial concentrations. Lead banking organizations in loan syndications should have policies and procedures in place that address whether or in what situations portions of syndications may be repurchased. Furthermore, banking organizations participating in a loan syndication should not place undue reliance on the credit analysis performed by the lead organization. Rather, the participant should have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the risks inherent in the transaction.

2129.05.4.2 Management Information and Risk-Measurement Systems

An institution's management information and risk-measurement systems should fully incorporate the risks involved in its secondary-market credit activities. Banking organizations must be able to identify credit exposures from all secondary-market credit activities and be able to measure, quantify, and control those exposures on a fully consolidated basis. The economic substance of the credit exposures of secondary-market credit activities should be fully incorporated into the institution's efforts to quantify its credit risk, including efforts to establish more formal grading of credits to allow for statistical estimation of loss probability distributions. Secondary-market credit activities should also be included in any aggregations of credit risk by borrower, industry, or economic sector.

It is particularly important that an institution's information systems can identify and segregate those credit exposures arising from the institution's loan-sale and securitization activities. Such exposures include the sold portions of participations and syndications, exposures arising from the extension of credit enhancement and liquidity facilities, the effects of an early amortization event, and the investment in asset-backed securities. The management reports should provide the board and senior management with timely and sufficient information to monitor the institution's exposure limits and overall risk profile.

2129.05.4.3 System of Internal Controls

One of management's most important responsibilities is establishing and maintaining an effective system of internal controls that, among other things, enforces the official lines of authority and the appropriate separation of duties in managing the risks of the institution. These internal controls must be suitable for the type and level of risks given the nature and scope of the institution's activities. Moreover, these internal controls should provide reasonable assurance of reliable financial reporting (in published financial reports and regulatory reports), includ-

ing adequate allowances or liabilities for expected losses.

2129.05.5 STRESS TESTING

The use of stress testing, including combinations of market events that could affect a banking organization's credit exposures and securitization activities, is another important element of risk management. Stress testing involves identifying possible events or changes in market behavior that could have unfavorable effects on the institution and assessing the organization's ability to withstand them. Stress testing should not only consider the probability of adverse events, but also likely "worst-case" scenarios. Such an analysis should be done on a consolidated basis and consider, for instance, the effect of higher-than-expected levels of delinquencies and defaults as well as the consequences of early amortization events with respect to credit card securities that could raise concerns regarding the institution's capital adequacy and its liquidity and funding capabilities. Stress test analyses should also include contingency plans regarding the actions management might take given certain situations.

2129.05.6 CAPITAL ADEQUACY

As with all risk-bearing activities, institutions should fully support the risk exposures of their secondary-market credit activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support *all* of the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. The Federal Reserve's risk-based capital guidelines establish *minimum* capital ratios, and those banking organizations exposed to high or above-average degrees of risk are, therefore, expected to operate significantly above the minimum capital standards.

The current regulatory capital rules do not fully incorporate the economic substance of the risk exposures involved in many secondary-market credit activities. Therefore, when evaluating capital adequacy, supervisors should ensure that banking organizations that sell assets with recourse, assume or mitigate credit risk through the use of credit derivatives, and provide direct credit substitutes and liquidity facilities to securitization programs are accurately identifying and measuring these exposures and maintaining capital at aggregate levels sufficient to support the associated credit, market, liquidity, reputational, operational, and legal risks.

Supervisors and examiners should review the substance of secondary-market transactions when assessing underlying risk exposures. For example, partial, first-loss direct credit substitutes providing credit protection to a securitization transaction can, in substance, involve much the same credit risk as that involved in holding the entire asset pool on the institution's balance sheet. However, under current rules, regulatory capital is explicitly required only against the amount of the direct credit substitute, which can be significantly different from the amount of capital that the institution should maintain against the concentrated credit risk in the guarantee. Supervisors and examiners should ensure that banking organizations have implemented reasonable methods for allocating capital against the economic substance of credit exposures arising from early amortization events and liquidity facilities associated with securitized transactions since such facilities are usually structured as short-term commitments to avoid a risk-based capital requirement, even though the inherent credit risk may be approaching that of a guarantee.[10]

If, in the supervisor's judgment, an institution's capital level is not sufficient to provide protection against potential losses from such credit exposures, this deficiency should be reflected in the banking organization's CAMELS or BOPEC ratings. Furthermore, supervisors and examiners should discuss the capital deficiency with the institution's management and, if necessary, its board of directors. Such an institution will be expected to develop and implement a plan for strengthening the organization's overall capital adequacy to levels deemed appropriate given all the risks to which it is exposed.

2129.05.7 INSPECTION OBJECTIVES

1. To determine whether there are risk-management systems and whether they accu-

10. For further guidance on distinguishing, for risk-based capital purposes, whether a facility is a short-term commitment or a direct credit substitute, see SR-92-11, "Asset-Backed Commercial Paper Programs." Essentially, facilities that provide liquidity, but which also provide credit protection to secondary-market investors, are to be treated as direct credit substitutes for purposes of risk-based capital.

rately identify all the risk exposures stemming from secondary-market activities.
2. To evaluate secondary-market credit activities and to determine if there has been a lowering of credit standards that could deteriorate the institution's financial condition during less favorable business and economic conditions.
3. To establish whether the institution's management system performs stress testing to evaluate the risk exposures of secondary-market credit activities under various scenarios and their potential effect on the institution's liquidity, earnings, and capital adequacy.
4. To review the substance of the institution's secondary-market transactions when assessing underlying risk exposures.
5. To ascertain whether liquidity contingency plans exist and to determine whether they fully incorporate the potential risk posed by secondary-market credit activities, including the need to obtain replacement funding.
6. To determine whether the board of directors is fully informed of the risks involved in secondary-market activities and whether they approve policies, controls, and procedures to control exposures arising from credit, liquidity, operational, legal, reputational, and other risks.
7. To determine whether the institution has a sufficiently strong capital position to support *all* the risk associated with secondary-market credit activities and that it has a capital plan for strenghtening its overall capital adequacy position.
8. To ascertain whether there is an effective system of internal controls—focused on lines of authority and the separation of duties—to monitor and contain the risks associated with secondary-market activities.

2129.05.8 INSPECTION PROCEDURES

1. Determine whether the institution's senior management is recognizing the risk involved in secondary-market credit activities by—
   a. determining if there is adequate identifying, quantifying, and monitoring of risk;
   b. clearly communicating the extent and depth of those risks in discussions, presentations, and inspection reports that are delivered to the board of directors and senior officials of the institution;
   c. presenting to the board of directors, for their approval, all significant policies relating to the risk management of secondary-market activities and the conditions under which a loan syndication can be purchased;
   d. determining whether management is conducting ongoing stress testing to identify potential losses and liquidity needs under adverse and "worst-case" scenarios; and
   e. making certain that senior management is setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding.
2. Assess whether the institution's systems and processes adequately identify, measure, monitor, and control all of the risks involved in the institution's secondary-market credit activities.
3. Determine whether the various risks associated with secondary-market activities are incorporated into contingency plans, including replacement funding plans and identified alternative funding sources, to lessen the impact of those risks.
4. Establish whether there is an adequate and effective system of internal controls that enforces official lines of authority and the appropriate separation of duties in managing the risks associated with secondary-market activities.
5. Review loan-syndication contract agreements, underwriting documentation, and relevant correspondence with loan syndication contractual parties to establish whether—
   a. the bank holding company's management has performed adequate credit investigations and evaluations of the syndicate loans, the syndicate participants, and the extent of the BHC's credit-risk exposures, and has complied with the Federal Reserve's know-your-customer rules (see footnote 9);
   b. the syndication customers are in a position to conduct their own investigations and evaluation of the credit risks involved in the transaction; and
   c. undue reliance is placed on the lead underwriter, the participants, or on their commercial-loan credit ratings.
6. For credit derivatives—
   a. analyze the credit risk associated with the reference asset, the general market risk, and the counterparty risk; and
   b. determine, for those reference assets that are not identical assets actually owned, whether the reference asset is an appropriate proxy for the loan or other assets

whose credit exposure is to be offset.

7. Review the substance of secondary-market transactions when evaluating and analyzing underlying risk exposures.
8. Evaluate and determine that there are reasonable methods for internally allocating capital against the economic substance of credit exposures that arise from amortization events and liquidity facilities associated with securitized transactions.
9. Incorporate the evaluation of potential risks and losses from credit exposures, including management deficiencies, into the institution's supervisory ratings.