

The international sections focus on the examination of risks and activities associated with international lending, financing instruments, and international banking. In addition to the sections that follow, information on the international aspects of cash accounts, nostro accounts, foreign collections, investments, and borrowed funds can be found in the applicable domestic sections:

- For foreign-currency cash accounts, see section 2000.1, “Cash Accounts.”
- For due from foreign banks—demand (nostro accounts) and foreign collections (cash letters, return items), see section 2010.1, “Due from Banks.”
- For foreign investments, see section 2020.1, “Investment Securities and End-User Activities.”
- For foreign governments and foreign political entities, see section 3000.1, “Deposit Accounts.”
- For international borrowed funds, see section 3010.1, “Borrowed Funds.”
- For foreign investments and foreign banking organizations, see section 4050.1, “Bank-Related Organizations.”

Additional information on international activities can be found in the *Bank Holding Company Supervision Manual*, *Trading and Capital-Markets Activities Manual*, *FFIEC Bank Secrecy Act Anti-Money Laundering Examination Manual*, and *FFIEC Information Technology (IT) Examination Handbook*.

# International—Examination Overview and Strategy

## Section 7000.1

Effective date May 2005

Generally, the basic procedures used for the examination and verification of international operations are the same as those used for other domestic bank functions. However, some procedures are modified for different types of bank assets and liabilities and contingent accounts, as well as for separate laws and regulations that may be applicable. Documentation and accounting procedures for international operations may also differ from those used in the domestic banking areas, but the same examination objectives apply. The examination process may also include a review of international banking facilities (IBFs) and periodic visits to selected foreign branches and subsidiaries to determine the safety and soundness of their operations and the adequacy of reporting procedures used by the head office or parent bank to monitor the foreign office.

The increasingly global nature of economic activities has made international banking operations more important to bank customers, importers and exporters of goods and services, and domestic customers with overseas operations who require a source of international financial assistance. As service institutions, commercial banks provide this assistance through global networks of representative offices, branches, and affiliates, as well as through correspondent relationships. These foreign networks also allow banks to offer services outside their traditional market areas. Additionally, in 1981, the Board of Governors amended regulations to allow for the establishment of IBFs in the United States. The activities of these facilities are limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institution establishing the IBF.

Many domestic banking activities are also conducted internationally, including providing cash and collection services, placing and taking deposits, making investments, granting loans and overdrafts, and borrowing. The international examiner will use the appropriate examination procedures for domestic operations when reviewing these activities. The examination procedures for the international aspects of these and other activities are covered in the following international sections.

Similarly, other activities that are primarily international are similar to activities found in the domestic banking area. For example, a confirmed letter of credit represents a formal

commitment to extend credit provided that certain collateral and documentary conditions exist. Foreign-exchange trading activities are similar to money-trading operations conducted at domestic funding desks. Foreign-exchange positions are similar to commodity inventories carried at book value that are exposed to fluctuating market prices. Separate international sections in this manual relate to these functions.

IBF activities are to be reviewed during the examination of international operations. The review of assets, internal controls, and operating procedures should be conducted using procedures similar to those used for offshore shell branches. In addition, reports required to be filed by IBFs should be reviewed to ensure that they are prepared properly and filed in a timely manner.

Additional international banking activities, such as direct lease financing, installment loans, real estate loans, real estate construction loans, ownership of bank premises and equipment, and other real estate owned are to be examined using the applicable procedures in section 2210.1, "Other Assets and Other Liabilities," and section 3020.1, "Assessment of Capital Adequacy." International examinations will also require reference to other sections of this manual. Guidelines for using these other sections in international examinations are provided below.

### WORKPAPERS

Workpapers should consist of written documentation of the examination procedures followed and of the conclusions reached during the examination of international operations. The definition, purpose, quality standards, preparation, and organization of workpapers used in international examinations are the same as those discussed in section 1030.1, "Workpapers."

### EXAMINATION STRATEGY

Careful planning and control are as important in international examinations as they are in domestic examinations. A number of the procedures found in section 1000.1, "Examination Strategy and Risk-Focused Examinations," also apply to international examinations.

When assigning work in the various examination areas, the examiner should consider the organization of the bank. For example, many banks have consolidated their foreign-exchange trading and money market operations into a single division that is responsible for the bank's global money market operations. Similar situations may be encountered for other international-related functions that are combined with domestic operations. Consequently, the examination assignments should address those situations.

In some examinations, the examiner may come across certain activities that are not addressed by any particular section of the international portion of this manual. In these instances, the examiner should extract the appropriate objectives, examination procedures, and internal control questionnaires from the domestic sections of this manual.

The examiner must be certain that all types of individual customer liabilities have been analyzed on a consolidated basis, regardless of the office where they are booked. However, since the procedures for the collection and consolidation of customer liabilities booked in overseas offices differ among banks, the examiner should determine whether the bank's procedures are adequate.

## INTERNAL CONTROL

The examiner should use section 1010.1, "Internal Control and Audit Function, Oversight, and Outsourcing," in the domestic portion of this manual to evaluate the objectives of and the work performed by internal and external auditors for the bank's international operations. The internal control section sets forth general criteria to be considered in evaluating the work of internal and external auditors.

## EXAMINATION PLANNING

Examiners assigned to review the international activities of the bank should work closely with commercial examiners, especially in those areas in which international and domestic activities have a direct relationship. This cooperation includes the pre-examination analysis of the bank and is intended to determine potential problem areas and provide for adequate staffing.

## COMPUTER SERVICES

During an examination that covers information technology (IT) and electronic data processing (EDP) services, provided either in-house or externally, the examiner should review the contents of the IT and EDP report of examination to determine which sections may be applicable to international operations. An IT-EDP examiner will generally perform the procedures in this section and should be consulted on matters applicable to international operations.

## ASSET AND LIABILITY MANAGEMENT

Asset and liability management (see section 4020.1) and interest-rate risk management (see section 4090.1) sections of the manual are completed by domestic examiners for the entire bank, based, in part, on information prepared by examiners assigned to various international banking activities. Whether applicable segments of these sections will be completed during overseas examinations depends on the type of overseas examination conducted.

## BANK-RELATED ORGANIZATIONS

The domestic examiner assigned to bank-related organizations (see section 4050.1) obtains and circulates lists and information to the international examiner concerning bank-related organizations involved in international activities. Besides determining the legality of the relationships, the international examiner should verify the accuracy and completeness of the information obtained.

## REVIEW OF REGULATORY REPORTS

The domestic examiner assigned to review regulatory reports (see section 4150.1) circulates the bank-prepared regulatory reports applicable to international operations. The international examiner will prepare any necessary comments on the appropriate report format and will discuss those comments with bank management.

## LITIGATION AND OTHER LEGAL MATTERS, EXAMINATION-RELATED SUBSEQUENT EVENTS

The international examiner should request from bank management a list of pending or threatened litigation and subsequent events applicable to international operations of the bank. Comments in the report should be limited to events or transactions that could materially affect the soundness of the bank. (See section 4100.1.)

## MANAGEMENT ASSESSMENT

The overall evaluation of the management of international operations should be made by the examiner assigned to review international operations who is in a position to identify the strengths and weaknesses of the management team. An appraisal of local management should

also be made if on-site examinations of foreign branches and subsidiaries are conducted.

## OVERALL CONCLUSIONS REGARDING CONDITION OF THE BANK

The examiner-in-charge is typically responsible for overall conclusions regarding the condition of the bank. (See section 5020.1.) However, the examiner assigned to review international operations must use judgment in deciding which steps in this section should be omitted. For example, certain examination procedures relating to earnings, liquidity, and ownership apply to the entire bank and not to the international area alone. However, international examiners should assist domestic examiners in developing report comments when international activities have a significant impact on the analysis of these areas.

*Acceptance.* A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the “acceptor,” stamps or writes the word “accepted” on the face of the draft and, above his or her signature, the place and date of payment. Once the draft is accepted, it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A *bank acceptance* is a draft drawn on, and accepted by, a bank. A *trade acceptance* is a draft drawn by the seller of goods on the buyer and accepted by the buyer. See also *Banker’s acceptance*.

*Account-account dealing.* Foreign-exchange dealing that involves settlement from bank-to-bank in the due from accounts. No third party (bank) is involved.

*Account party.* The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

*Ad valorem.* A term meaning “according to value,” used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

*Advance.* (1) A drawing or payout of funds representing the disbursement of a loan, including disbursement in stages. (2) In international banking, an extension of credit, usually recurring, in which no instrument (other than a copy of the advice of an advance) is used as evidence of a specified indebtedness, except in special cases. A signed agreement must be on file in the department and state the conditions applicable to payments made to the borrower. This loan category does not include commercial account overdrafts, but an advance may be created to finance payments effected under a commercial letter of credit, to finance payments of collections, or to refinance a maturing loan.

*Advance against documents.* An advance made on the security of the documents covering a shipment.

*Advised letter of credit.* See *Letter of credit—advised*.

*Advised line.* A credit authorization that will be made known to the customer. See also *Guidance line*.

*Affiliate.* With regard to a member bank, any company (including corporate or other forms of a business entity) of which a member bank is a

subsidiary or any other subsidiary of that company.

*After sight.* When a draft bears this name, the time to maturity begins at its presentation or acceptance.

*Agent bank.* The bank that leads and documents a syndicated loan.

*Aggregate limit.* The total volume of unliquidated foreign-exchange contracts allowed to be outstanding at any one time.

*Agreement corporation.* A company chartered or incorporated under state law that, like an Edge Act corporation, is principally engaged in international banking. See also *Edge Act*.

*Allocated transfer-risk reserve (ATRR).* The ATRR is a special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983.<sup>1</sup> At least annually, the Federal Reserve and the other federal banking agencies (federal banking agencies) determine jointly—

- which international assets that are subject to transfer risk warrant establishment of an ATRR,
- the amount of the ATRR for the specified assets, and
- whether an ATRR previously established for specified assets may be reduced.

When determining whether an ATRR is required for particular international assets, the federal banking agencies consider if the quality of a banking institution’s assets has been impaired by a protracted inability of public or private obligors in a foreign country to make payments on their external indebtedness, as indicated by factors as to—

- whether such obligors have failed to make full interest payments on external indebtedness, or
- whether such obligors have failed to comply with the terms of any restructured indebtedness, or
- whether a foreign country has failed to comply with any International Monetary Fund (IMF) or other suitable adjustment program, or
- whether no definite prospects exist for the orderly restoration of debt service.

1. See 12 USC 3904(a). See also the Board’s January 9, 2003, approval of a revision to subpart D (on international lending supervision) of Regulation K (12 CFR 211), International Banking Operations (69 *Fed. Reg.* 1158–1161).

Also, when determining the amount of the ATRR, the federal banking agencies consider—

- the length of time the quality of the asset has been impaired,
- what recent actions have been taken to restore debt-service capability,
- the prospects for restored asset quality, and
- any other factors relevant to the quality of the asset.

The initial year's provision for the ATRR will be 10 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies. Additional provisions, if any, in subsequent years will be 15 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies.

The ATRR is established only by a charge to current income. The amounts charged cannot be included in the banking institution's capital or surplus. (For these and other requirements, as well as for certain other accounting procedures for the ATRR, the reporting and disclosure of international assets, and the accounting for fees on international loans, see sections 211.43, 211.44, and 211.45 of Regulation K.) A banking institution does not have to establish an ATRR if it writes down in the period in which the ATRR is required, or has written down in prior periods, the value of the specified international assets in the requisite amount for each such asset.

*Amortizing swap.* A transaction in which the notional value of the agreement declines over time.

*Appreciation.* A rise in the value of a currency relative to the market of another currency.

*Arbitrage.* Simultaneous buying and selling of foreign currencies, securities, or commodities to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

*Asian currency unit.* A foreign-exchange trading department of a bank located in Singapore that has received a license from the monetary authority in that country to deal in external currencies.

*Asked price.* The price sought by any prospec-

tive seller of an asset or the price at which a market maker of an asset will sell.

*Assignment.* The transfer in writing by one person to another of title to personal property. In banking, one bank may assign another the right to receive loan principal and interest from a borrower. The assignment of stocks or registered bonds may be effected by filling in the form printed on the reverse of the certificate.

*Association of International Bond Dealers (AIBD).* A private association founded in Zurich, Switzerland, in 1969 to establish uniform issuing and trading procedures in the international bond markets.

*At sight.* A term indicating that a negotiable instrument is payable upon presentation or demand.

*At the money.* A term used to refer to a call or put option whose strike price is equal (or virtually equal) to the current price of the asset on which the option is written.

*Authority to pay.* An advice from a buyer, sent by his or her bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's American bank.

*Authority to purchase.* Similar to an authority to pay, except that drafts under an authority to purchase are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay, they are usually not confirmed by an American bank. This type of transaction is unique to Far Eastern trade.

*Baker Plan.* Proposed in 1985, this initiative encouraged banks, the IMF, and the World Bank to jointly increase lending to less developed countries (LDCs) that were having difficulty servicing their debt, provided the countries undertook prudent measures to increase productive growth.

*Balance of payments.* A term indicating a nation's external cash flow (to other countries, whether positive or negative) for a given period of time, including trade, current financial, and capital inflows and outflows.

*Balance of trade.* The difference between a country's total imports and total exports for a

given period of time. A “favorable” balance of trade exists when exports exceed imports.

**Band.** The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

**Bank for International Settlements (BIS).** Established in 1930 in Basel, Switzerland, the BIS is the oldest functioning international financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues.

**Banker's acceptance.** A time draft that has been drawn on and accepted by a bank. The bank accepting the time bill becomes primarily liable for payment. See also *Acceptance*.

**Banker's acceptance liability.** The moment the draft is accepted by the bank, a direct liability is recorded in its “Acceptances Executed” account. The contra account on the asset side of the balance sheet is “Customer's Liability on Acceptances.” On the date of maturity of the banker's acceptance, the bank charges the customer's account and retires the acceptance by paying the beneficiary or drawee of the draft. The bank's liability records at this point are liquidated, and the transaction is completed.

**Barter.** The exchange of commodities using merchandise as consideration instead of money. This scheme has been employed in recent years by countries that have blocked currencies.

**Base rate.** A rate used as the basis or foundation for determining the current interest rate to be charged to a borrower, such as the prime rate or London Interbank Offered Rate (LIBOR).

**Basel Capital Accord.** An agreement among the central banks of leading industrialized countries, including those of Western Europe, Canada, the United States, and Japan, to impose common capital requirements on their internationally active banks to take into account bank risk exposure.

**Basis.** The cash or spot price minus the futures price.

**Basis risk.** The risk associated with nonparallel movement of interest rates. Banks face exposure in two situations. The first occurs when an operator uses, for example, a Treasury bill to hedge an interest-rate risk in Eurodollars. The interest rates for T-bills and Eurodollars do not always move exactly parallel to each other. The risk of this lack of parallel movement is basis risk. The second occurs when the period of time for which a financial risk exists is not identical with the period of time for which the

hedge is arranged, for example, when a three-month interest risk in a revolving Eurodollar loan is hedged with a six-month futures contract in Eurodollars. A change in the shape of the yield curve can bring about nonparallel movements in interest rates for the two different maturities.

**Basis swap.** A transaction in which one participant pays a floating rate of interest based on one index, and the other party pays a floating rate of interest based on another interest-rate index.

**Beneficiary.** The person or company in whose favor a letter of credit is opened or a draft is drawn.

**Bid-asked spread.** The difference between a bid and the asked price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

**Bid rate.** The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

**Bilateral trade.** Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

**Bill of exchange.** An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms “bill of exchange” and “draft” are generally interchangeable.

**Bill of lading.** A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, document of title, and contract between the carrier and the shipper covering the delivery of the merchandise to a certain point or designated person. It is issued in two primary forms: an “order bill of lading,” which provides for the delivery of goods to a named person or to his or her order (designee), but only on proper endorsement and surrender of the bill of lading to the carrier or its agents, and a “straight bill of lading,” which provides for delivery of the goods only to the person designated by the bill of lading.

• **Clean bill of lading.** A bill of lading in which the described merchandise has been received

in “apparent good order and condition” and without qualification.

- *Ocean bill of lading.* A document signed by the captain, agents, or owners of a vessel furnishing written evidence for the conveyance and delivery of merchandise sent by sea. It is both a receipt for merchandise and a contract to deliver it as freight.
- *Order bill of lading.* A bill of lading, usually drawn to the order of the shipper, that can be negotiated like any other negotiable instrument.
- *Order “notify” bill of lading.* A bill of lading usually drawn to the order of the shipper or a bank with the additional clause that the consignee is to be notified upon arrival of the merchandise. However, the mention of the consignee’s name does not confer title to the merchandise.
- *Stale bill of lading.* A bill of lading that has not been presented under a letter of credit to the issuing bank within a reasonable time after its date, thus precluding its arrival at the port of discharge by the time the ship carrying the related shipment has arrived.
- *Straight bill of lading.* A bill of lading drawn directly to the consignee and therefore not negotiable.
- *Through bill of lading.* A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.
- *Unclean bill of lading.* A bill of lading across the face of which exceptions to the receipt of goods “in apparent good order” are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

*Black market.* A private market that operates in contravention of government restrictions.

*Blocked account.* An account from which payments, transfers, withdrawals, or other dealings may not be made without Office of Foreign Asset Control (OFAC) or U.S. Treasury Department approval. Although the bank is prohibited from releasing funds from these accounts, deposits may be accepted. Banks are subject to significant fines for releasing funds from blocked accounts. See also *Office of Foreign Asset Control, Specially designated nationals.*

*Blocked currency.* A currency that is prohibited by law from being converted into another foreign currency.

*Book-entry form.* The method by which marketable securities are issued with the buyer receiving only a receipt rather than an engraved

certificate, which indicates that the purchase is recorded on the issuer’s books or recorded in another approved location.

*Brady Plan.* Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

*Break-even exchange rate.* The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency (which has not been covered in the forward market) so that there will be no advantage to any party from interest-rate differentials.

*Bulldog bonds.* British pound sterling-denominated foreign bonds issued in London.

*Bullion.* Unminted precious metals (gold, silver) of standard or stipulated fineness in the form of bars, ingots, or nuggets. The value of gold bullion, usually in bars, used in the settlement of international balances is determined by weight and degree of fineness.

*Buyer’s option contract.* A contract in which the buyer has the right to settle a forward contract at any time within a specified period. See also *Option contracts.*

*Buying rates.* Rates at which foreign-exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

*C & I loans.* Commercial and industrial loans.

*Cable.* A message sent and delivered by an international record carrier via satellite or cable connections to a foreign country. “Cable” as used in the international sections also includes messages transmitted by bank telex. The terms “cable” and “telex” are generally used interchangeably.

*Call money.* Funds placed with a financial institution without a fixed maturity date. The money can be “called” (withdrawn) at any time by telephone. “Same day” call money means the call must (usually) be made before 10:00 a.m. In addition, “24-hour,” “48-hour,” and “7-day” call money means the money must be called one, two, or seven calendar days before the actual payment date. Although these are the most common varieties of call money, two parties can agree on different dates.

*Call option.* A contract giving the purchaser the right, but not the obligation, to buy an asset at a stated price on or before a stated date.

*Capital controls.* Governmental restrictions

on the acquisition of foreign assets or foreign liabilities by domestic citizens or restrictions on the acquisition of domestic assets or domestic liabilities by foreign citizens.

*Cedel.* Formerly one of the two main clearing systems in the Eurobond market, Cedel, based in Luxembourg, began operations in 1971. Cedel ceased to exist as an independent entity as part of a merger with Clearstream International clearinghouse in 2000. The merger was completed in 2002.

*Central bank intervention.* Direct action by a central bank to increase or decrease the supply of currency to stabilize prices in the spot or forward market or to move them in a desired direction. On occasion, the announcement of an intention to intervene might achieve the desired results.

*Certificate of inspection.* A document often required for shipment of perishable goods in which certification is made as to the good condition of the merchandise immediately before shipment.

*Certificate of manufacture.* A statement, sometimes notarized, by a producer who is usually also the seller of merchandise that manufacture has been completed and that goods are at the disposal of the buyer.

*Certificate of origin.* A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment to products of certain countries.

*Chain.* A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for Japanese yen against U.S. dollars and for Swiss francs against U.S. dollars, the “chain” makes possible a calculation of the cross rates for Japanese yen against Swiss francs.

*Charges forward.* A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawee.

*Charges here.* A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawer.

*Charter party.* A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel, setting forth the terms of the arrangement, such as freight rate and ports

involved in the trip contemplated.

*Chicago Board of Trade (CBT).* A futures exchange that merged with the Chicago Mercantile Exchange in 2007 and ceased to exist as an independent entity.

*Chicago Board Options Exchange (CBOE).* An options exchange in which European foreign-currency options on spot exchange are traded.

*Chicago Mercantile Exchange (CME).* A futures exchange.

*Clean collection.* A collection in which a draft or other demand for payment is presented without additional attached documentation.

*Clean draft.* A sight or time draft to which no other documents, such as shipping documents, bills of lading, or insurance certificates, are attached. This is to be distinguished from a documentary draft. See also *Documentary draft*.

*Clean risk at liquidation.* A type of credit risk that occurs when exchange contracts mature. There may be a brief interval (usually no more than a few hours) during which one of the parties to the contract has fulfilled its obligations, but the other party has not. During this period, the first party is subject to a 100 percent credit risk, on the chance that, in the interval, an event may prevent the second party from fulfilling its obligations under the contract.

*Clearing corporation.* A clearinghouse that exists as an independent corporation rather than as a subdivision of an exchange.

*Clearinghouse.* A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

*Clearinghouse funds.* Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

*Clearing House Interbank Payments System (CHIPS).* A computerized telecommunications network provided by the New York Clearing House Association (NYCHA), which serves as an automated clearinghouse for interbank funds transfers.

*Closing a commitment.* Allowing a covered foreign-exchange position to expire on maturity or reversing it before maturity by a swap operation.

*Closing a position.* Covering open long or short positions by means of a spot operation and/or outright forward operation.

*Comanager.* A bank ranking just below that of lead manager in a syndicated Eurocredit or an international bond issue. The status of comanager usually indicates a larger share in the

loan or a larger bond allotment, and a larger share in the fees, than banks of lower rank. Comanagers may also assist the lead managers in assessing the market or determining terms of the loan.

*Combined transport document.* A through bill of lading that applies to more than one mode of transport.

*Commercial paper.* A short-term, unsecured debt instrument issued by a corporation and sold at a discount from its maturity value.

*Commercial transaction.* A transaction between a dealing bank and a nonbanking (commercial) party.

*Commodities Futures Trading Commission (CFTC).* A U.S. regulatory body that regulates exchange-based futures trading in the United States.

*Commodity Credit Corporation (CCC).* An instrument of the federal government whose principal purpose is to provide the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

*Common carrier.* An individual, partnership, or corporation, such as a shipping line, railroad, or airline, that undertakes for hire to transport persons or commodities from place to place. Governed by special laws, common carriers must accept all business offered them under their regulations.

*Compromises.* Occasions when both parties agree to alter the terms of an existing foreign-exchange contract. These alterations should be approved by an impartial bank officer and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original terms.

*Confirmation.* The written communication to the counterparty in a foreign exchange, inter-bank deposit, or other money market transaction that recites all the relevant details agreed upon by phone or telex.

*Confirmed letter of credit.* See *Letter of credit*.

*Consignment.* The physical transfer of goods from a seller (consignor), with whom the title remains, to another legal entity (consignee), who acts as a selling agent, selling the goods and remitting the net proceeds to the consignor.

*Consular documents.* Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

*Consular invoice.* A detailed statement on the character of goods shipped, which is duly certified by the consul at the port of shipment. Required by certain countries, including the United States, its principal function is to accurately record the types of goods and their quantity, grade, and value for import duty and general statistical purposes.

*Contract limit.* A maximum limit on the total gross notional principal amount of outstanding contracts booked with one customer.

*Contract risk (counterparty risk).* Risk that the counterparty will default before settlement.

*Convertibility.* Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

*Correspondent bank.* A bank located in one geographic area that accepts deposits from a bank in another region and provides services on behalf of this other bank. Internationally, many banks maintain one account with a correspondent bank in each major country to be able to make payments in all major currencies. Correspondent banks are usually established on a reciprocal basis.

*Cost, insurance, and freight (C.I.F.).* A price quotation under which the seller defrays all expenses involved in the delivery of goods.

*Counterpart funds.* Local currencies deposited in a special account by recipient governments that represent grant aid extended by another government. Those funds, while remaining the property of the recipient government, can generally be used only by agreement of the donor government.

*Country exposure.* A measurement of the volume of assets and off-balance-sheet items considered to be subject to the risk of a given country. This measurement is based, in part, on identifying the country of domicile of the entity ultimately responsible for the credit risk of a particular transaction.

*Country limit.* The amount of money that a bank has established as the maximum it is willing to lend borrowers in a given country regardless of the type of borrower or the currencies involved.

*Country risk.* Refers to the spectrum of risks arising from the economic, social, and political environment of a given foreign country, which could have favorable or adverse consequences for foreigners' debt and/or equity investments in that country.

*Cover.* The execution of an offsetting foreign-

exchange trade to close or eliminate an open exposure.

*Covered interest arbitrage.* The process of taking advantage of a disparity between the net accessible interest differential between two currencies and the forward exchange premium or discount on the two currencies against each other.

*Crawling peg system.* An exchange-rate system in which the exchange rate is adjusted every few weeks, usually to reflect prevailing inflation rates.

*Credit risk.* The possibility that the buyer or seller of foreign exchange or some other traded instrument may be unable to meet his or her obligation on maturity.

*Credit swap.* A link transaction wherein one party places a deposit in one currency (probably dollars) with a foreign bank during the period that the foreign bank lends another currency to a third party. The deposit serves as an inducement for the transaction, and its value is considered in pricing the loan.

*Cross-border exposure.* The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

*Cross-currency risk.* The risk associated with maintaining exchange positions in two foreign currencies as the result of one transaction. For example, if a U.S. operator borrows Swiss francs at 5 percent and invests the proceeds in British pounds at 12 percent, the cross-currency risk is the chance that the pounds will depreciate in value against the Swiss francs to such an extent that there will be a loss on the transaction in spite of the favorable interest-rate differential.

*Cross-default.* A term used to describe a clause in a syndicated loan or bond contract that gives the lender the right to accelerate repayment of the loan if the borrower defaults on another loan.

*Cross-hedging.* The hedging of an asset with a futures contract of a different asset.

*Cross rate.* The ratio between the exchange rates of two foreign currencies in terms of a third currency.

*Currency futures and options contracts.* An agreement that allows businesses or individuals acquiring or selling foreign currencies to protect themselves against future fluctuations in currency prices by shifting currency risk to someone willing to bear that risk.

*Currency liquidity.* In a multicurrency investment portfolio, the liquidity of a given foreign

currency has to be viewed in terms of exchange liquidity and instrument liquidity. Exchange liquidity depends on the ease with which a currency can be converted into and out of another major currency. Instrument liquidity depends on the ease with which a negotiable instrument denominated in that currency can be purchased and sold without noticeably affecting the market rate for that instrument.

*Currency swap.* A contractual obligation entered into by two parties to deliver a sum of money in one currency against a sum of money in another currency at stated intervals (or a stated interval) or according to negotiated terms. See *Swap*.

*Current account.* Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers.

*Customs union.* An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

*Date draft.* A draft drawn to mature on a fixed date, regardless of its acceptance.

*Daylight limit.* The maximum net foreign-exchange position that a bank will allow during business hours.

*Dealer (or trader).* A person who executes foreign-exchange, interbank deposit, or other money market trades for a dealing bank.

*Debt for equity swaps.* Debt (usually LDC government debt) that is discounted and exchanged for equity in local businesses (often newly privatized).

*Debt swaps.* The exchange of LDC loans based on the prices quoted in the secondary market. Swaps are often used to decrease exposure to certain countries.

*Default risk.* The risk to the holder of debt securities that a borrower will not meet all promised payments at the times agreed upon.

*Del credere agent.* A sales agent who, for a certain percentage above his or her sales commission, guarantees payment to the person for whom he or she is selling on shipments made to the seller's customers.

*Delivery.* The offset of an obligation to buy or sell an asset by an actual transfer of title to the asset at a prearranged price. In the futures market, the transfer or receipt of a cash instrument against a short or long futures contract.

*Delivery order.* An order addressed to the holder of goods and issued by anyone who has

authority to do so, that is, by one who has the legal right to order delivery of merchandise. A delivery order is not considered a good titled document.

*Delivery risk.* The possibility that a seller of foreign exchange, having collected the payment in local currency, may fail to deliver the exchange in the foreign center where it was sold. Also called settlement risk.

*Delta of an option.* The rate of change of the value of an option with respect to the price of the underlying asset, reference rate, or index evaluated at the current market price of that underlier.

*Demand draft.* A draft that is payable immediately upon presentation to the drawee. This type of draft is also termed a “sight” or “presentation” draft.

*Deposit dealer.* A term used in the United States for bank personnel responsible for lending and borrowing funds in the interbank market.

*Deposit trader.* A term used in Europe for bank personnel responsible for lending and borrowing funds in the interbank market.

*Depreciation.* A drop in the value of a currency relative to the value of another currency.

*Depth of the market.* The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

*Derivative instrument.* An instrument that is based on or derived from the value of an underlying asset, reference rate, or index. For example, interest-rate futures are based on various types of securities trading in the cash market. Some interest-rate options are derived from interest-rate futures.

*Devaluation.* An official act wherein the official parity of a country’s currency is adjusted downward to the dollar, gold, Special Drawing Rights (SDRs), or another currency. After a devaluation, there are more devalued currency units relative to the dollar, gold, SDRs, or other currency. See also *Revaluation*.

*Development bank.* A lending agency that provides assistance to encourage economic development.

*Direct quote.* The method of quoting fixed units of foreign exchange in variable numbers of the local currency unit. Also called a “fixed” or “certain” quotation.

*Dirty float (or Managed float).* A floating

exchange-rate system in which some government intervention still takes place. A government may announce that it will let its currency float, that is, it will let the currency’s value be determined by the forces of supply and demand in the market. The government, however, may secretly allow its central bank to intervene in the exchange market to avoid too much appreciation or depreciation of the currency.

*Discount.*

- *Lending*—To subtract from a loan, when it is first made, the amount of interest that will be due when it is repaid.
- *Foreign exchange*—The amount by which the forward exchange rate of one currency against another currency is less than the spot exchange rate between the two currencies.
- *Financial*—A deduction from the face value of commercial paper, such as bills of exchange and acceptances, in consideration of cash the seller has received before the maturity date. The rates of discount vary according to the state of the given money market, the financial standing of the persons involved, and other circumstances surrounding the transaction.
- *Commercial*—An allowance from the quoted price of goods, usually made by the deduction of a certain percentage from the invoice price.

*Discount rate.* Most commonly the rate at which a Federal Reserve Bank (or, in many instances, foreign central banks) is prepared to lend to financial institutions against eligible collateral.

*Dishonor.* Refusal on the part of the drawee to accept a draft or to pay it when due.

*Divergence indicator system.* One aspect of the European Monetary System that measures the departure of a country’s economic policies from the European Union’s “average.” The measure of divergence is based exclusively on the movement of a country’s exchange rate with respect to the euro.

*Dock receipt.* A receipt issued by an ocean carrier or its agent for merchandise delivered at its dock or warehouse that is awaiting shipment.

*Documentary collection.* A collection in which a draft is accompanied by shipping or other documents.

*Documentary credit.* A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of merchandise, against delivery of documents specified in the credit.

*Documentary draft.* A draft to which docu-

ments are attached, that is delivered to the drawee upon acceptance or payment of the draft and that ordinarily controls title to the merchandise.

*Documents.* The shipping and other papers customarily attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

*Documents against acceptance (D/A).* Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her acceptance of the draft.

*Documents against payment (D/P).* Instructions given by an exporter to his or her bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her payment of the draft.

*Domestic bond.* A domestic debt security sold by an issuer in its own country and denominated in that country's currency.

*Domicile.* The place where a draft or acceptance is made payable.

*Draft.* An order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment at a determinable future time to a third party (the payee). It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. See also *Sight draft* or *Time draft*.

*Dragon bond.* A bond issued by a foreign borrower in an Asian or Pacific country (excluding Japan—see *Samurai bond*).

*Drawee.* The addressee of a draft, that is, the person on whom the draft is drawn.

*Drawer.* The issuer or signer of a draft.

*Duration.* A time-weighted present-value measure of the cash flow of a loan or security that takes into account the amount and timing of all promised interest and principal payments associated with that loan or security.

*Duty.* (1) Ad valorem duty (according to the value) is an assessment at a certain percentage rate on the actual value of an article. (2) Specific duty is an assessment on the weight or quantity of an article without reference to its monetary value or market price. (3) Drawback is a recovery in whole or in part of duty paid on imported merchandise at the time of reexportation, whether in the same or different form.

*Edge Act.* Incorporated as section 25A of the Federal Reserve Act, this act authorizes the Board of Governors to charter corporations (Edge corporations) for the purpose of engaging in international or foreign banking or in other international operations.

*Eligible acceptance.* A banker's acceptance that meets Federal Reserve requirements related to its financing purpose and term.

*Eligible value date.* A normal business day on which a payment to settle a money market transaction can be made. An eligible value date for a foreign-exchange transaction must be a business day in the home countries of both of the currencies involved.

*Engineered swap transaction.* A spot transaction and an offsetting forward transaction in which each of the two transactions is carried out with a different party.

*Eurobank.* A bank that regularly accepts foreign currency-denominated deposits and makes foreign-currency loans.

*Eurobonds.* Long-term debt securities denominated in a currency other than that of the country or countries where most or all of the security is sold.

*Euroclear.* Euroclear Clearance System Limited is one of two main clearing systems in the Eurobond market. Euroclear, which began operations in December 1968, is located in Brussels and managed by Euroclear Bank SA. See also *Cedel*.

*Eurocurrency.* The nonresident ownership of one of the major western European currencies. Eurocurrencies, similar to Eurodollars, are frequently available for borrowing in the London Interbank Market.

*Eurocurrency market.* The money market for borrowing-and-lending currencies that are held in the form of deposits in banks located outside the countries in which those currencies are issued as legal tender.

*Eurodollars.* Dollar deposit claims on U.S. banks that are deposited in banks located outside the United States, including foreign branches of U.S. banks. These claims, in turn, may be redeposited with banks or lent to companies, individuals, or governments outside the United States.

*Eurodollar deposit rate.* The interest rate at which a quoting bank is willing to take wholesale Eurodollar funds with a particular maturity from other than an interbank participant. The rate is usually one-eighth to one-sixteenth of one percent lower than LIBOR.

*European Currency Unit (ECU).* A portfolio currency used in the European Monetary System as a community “average” exchange rate. It was also used in the private market as a means of payment and as a currency of denomination for lending, borrowing, and trade. On January 1, 1999, the euro replaced the ECU.

*European Monetary System (EMS).* An arrangement introduced in March 1979 for economic and monetary cooperation among the members of the European Union. The ultimate aim of the EMS is a single European currency and the establishment of a European central bank.

*European Union (EU).* Formerly the European Community, an economic association of European countries founded by the Treaty of Rome in 1957. The goals of the EU are the removal of trade barriers among countries, the formation of a common commercial policy toward non-EU countries, and the removal of barriers restricting competition and the free mobility of factors of production. Members include Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

*Exchange contracts.* Documents issued by foreign-exchange dealers, banks dealing in foreign exchange, and foreign-exchange brokers confirming foreign-exchange transactions.

*Exchange control or restrictions.* Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

*Exchange control risk.* The possibility of defaults on obligations by imposing or reinforcing exchange control.

*Exchange-rate differential.* The difference between two exchange rates in a swap transaction.

*Exchange rates.* The price of one currency in terms of another. See also *Spot exchange*, *Buying rates*, *Fixed rate of exchange*, *Floating rate*, and *Interbank rate of exchange*.

*Exchange reserves.* The total amount of freely convertible foreign currencies held by a country’s central bank.

*Exchange risk.* The possibility of a loss on an open position as a result of an appreciation or depreciation of the exchange.

*Exercise.* The use of the right given by an option: purchase (if a call) or sale (if a put) of an

asset at the strike price stated in the option contract.

*Exit bonds.* Low-interest government bonds issued in LDCs that are equivalent to a portion of the country’s existing bank debt. Designed to facilitate debt management.

*Expiration date.* The last day on which an option may be exercised.

*Export credit insurance.* A system to insure the collection of credits extended by exporters against various contingencies. In some countries, only noncommercial risks can be insured.

*Export declaration.* A document required by the U.S. government for shipments abroad and used to maintain statistics on our exports.

*Export-Import Bank of the United States (Eximbank).* An institution that provides intermediate and long-term nonrecourse financing for U.S. exports when these facilities are not available from commercial banks. All of the Eximbank’s shares are held by the U.S. Treasury.

*Export trading company (ETC).* A company designed to facilitate U.S. exports. An ETC may be an affiliate of a bank holding company.

*Fail.* Nonperformance of an obligation on the specified day, for example, failure to make prompt settlement for either side of a foreign-exchange contract, usually due to a clerical or trader error. A fail usually leads to an interest adjustment for an overdraft in the paying or receiving bank.

*F.A.S.* See *Free alongside ship*.

*Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).* This act had various aims, including the least-cost resolution of troubled insured depository institutions, improvement of bank supervision and examinations, and provision of additional resources to the Bank Insurance Fund.

*Federal funds.* Deposits held by commercial banks at a Federal Reserve Bank. Since reserve requirements of commercial banks are satisfied by federal funds, banks with deposits in excess of required reserves will lend the excess deposits to banks with a reserve shortage at a market-determined interest rate, called the federal funds rate.

*Federal Reserve System.* The central bank of the United States, created by the Federal Reserve Act of 1913, consisting of the Board of Governors in Washington, D.C., and 12 regional Federal Reserve Banks. The Federal Reserve controls the country’s monetary base and has the power to set reserve requirements, conduct open-market operations, and lend directly to banks.

**Fedwire.** The large-value payment mechanism owned and operated by the Federal Reserve System. Fedwire provides depository institutions with real-time settlement in the central bank of funds transfers and book-entry securities transfers made for their own account or on behalf of their customers.

**Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).** The purpose of this act was to reform, recapitalize, and consolidate the federal deposit insurance system and to enhance the regulatory and enforcement powers of federal financial institutions' regulatory agencies.

**Fixed exchange-rate system.** A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

**Fixed rate of exchange.** A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps Special Drawing Rights. It remains in effect as long as that government is willing or able to buy and sell at the set rates.

**Fixed-rate payer.** A position applicable to a rate swap, in which the fixed payer pays the fixed rate and receives the floating rate.

**Flexible rate of exchange.** A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, Special Drawing Rights, or another currency when the rate fluctuates beyond certain parameters.

**Floating exchange-rate system.** A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

**Floating rate.** A rate of exchange that is determined completely by market forces, with no floor or ceiling vis-a-vis the dollar, gold, Special Drawing Rights, or another currency.

**Floating-rate notes.** Bonds that pay interest at an agreed margin above a market reference rate. The interest rate varies according to variations in the market reference rate.

**Floating-rate payer.** A position applicable to a rate swap, in which the floating payer pays the floating rate and receives the fixed rate.

**F.O.B.** See *Free on board (destination or vessel)*.

**Foreign Bank Supervision Enhancement Act (FBSEA).** Part of the FDIC Improvement Act of 1991, FBSEA expanded the supervisory author-

ity of the Federal Reserve over the U.S. operations of foreign banks.

**Foreign bonds.** Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

**Foreign Credit Insurance Association (FCIA).** An insurance company established under the auspices of Eximbank. Insurers trade credits granted by U.S. suppliers of products to purchasers abroad who qualify as normal risks. The insurance protects the exporter, up to an agreed percentage, against any nonpayment resulting from commercial or political risks, or both. Eximbank provides reinsurance for the entire portion of the commercial credit risk and is the sole insurer of the political risk.

**Foreign currency.** The currency of any foreign country that is the authorized medium of circulation and the basis for recordkeeping in that country. Foreign currency is traded by banks either by the actual handling of currency and checks or by the establishment of balances in foreign currencies with banks in those countries.

**Foreign deposits.** Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also *Nostrro account*.

**Foreign draft.** An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

**Foreign exchange.** The trading or exchange of a foreign currency in relation to another currency.

**Foreign-exchange futures contracts.** Standardized contracts traded on an organized futures exchange and settled through the clearinghouse of the exchange. Each contract defines the currencies, contract amounts, and delivery dates for its own contracts.

**Foreign-exchange market.** Communications between dealers and brokers to transact wholesale business in foreign exchange and Eurocurrencies.

**Foreign-exchange rationing.** A government requirement that all holders of bills of exchange relinquish them at a stipulated rate.

**Foreign-exchange reserves (official).** The reserves maintained by a central bank, which usually include gold and easily traded currencies of major industrial nations.

**Foreign-exchange risk.** The risk associated

with exposure to fluctuation in spot exchange rates.

*Foreign Investment Advisory Service (FIAS).* Established in 1986, FIAS counsels developing countries on attracting foreign capital. FIAS operates under the aegis of the World Bank and its affiliates, the International Finance Corporation and the Multilateral Investment Guarantee Agency.

*Foreign trade zone.* An area where goods may be received and stored without entering a country's customs jurisdiction and without paying duty. Sometimes called a "free trade zone."

*Forward book.* The aggregate of all forward contracts for a given currency or all currencies.

*Forward contract.* A contract that obligates one party to sell and another to buy a specific asset for a specified price at a designated time.

*Forward discount ("at a forward discount").* A phrase used to describe a currency whose forward price is cheaper than its spot price.

*Forward exchange.* Foreign currency traded for settlement beyond two working or business days from today.

*Forward exchange position.* The long or short position that a dealer may have in the forward market, as compared to spot dealing.

*Forward exchange risk.* The possibility of a loss on a covered position as a result of a change in the swap margin.

*Forward-forward dealing.* The simultaneous purchase and sale of a currency for different forward dates.

*Forward premium ("at a forward premium").* A phrase used to describe a currency whose forward price is more expensive than its spot price.

*Forward purchase.* An outright purchase of a forward contract.

*Forward rates.* The actual rates at which foreign exchange for future delivery are quoted, bought, and sold.

*Forward swap.* A transaction in which the initial fixed- and floating-rate payments are deferred until a future period of time.

*Forward transaction date.* Value dates that are more than two business days following the trade date. Regular forward dates are 30, 60, and 90 days from the trade date.

*Free alongside ship (F.A.S.).* A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays lighterage expenses up to that destination, if necessary.

*Free on board (F.O.B.) (destination).* A term

for a price quotation under which the seller undertakes at his or her risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

*Free on board (F.O.B.) (vessel).* A term for a price quotation under which the seller delivers the goods at his or her expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

*Free port.* A foreign trade zone, open to all traders on equal terms, where merchandise may be stored duty-free pending its reexport or sale within that country.

*Free trade area.* An arrangement between two or more countries for free trade among themselves, although each nation maintains its own independent tariffs toward nonmember nations. It should not be confused with "free trade zone," which is synonymous with "foreign trade zone."

*Fungible securities.* Securities that are not individually designated by serial number as belonging to a particular owner. Instead, a clearing system or depository institution credits owners with a given number of a particular bond issue (or other security issue). The owner may have title to 50 bonds, but not to 50 specific bonds with designated serial numbers.

*Futures commission merchant (FCM).* A firm that is registered with the CFTC and legally authorized to solicit or accept orders from the public for the purchase or sale of futures contracts. Acts as an intermediary between a public customer and a floor broker.

*Futures contract.* An exchange-traded contract in which one party agrees to buy a security and another agrees to sell a security in the future. If held until maturity, the futures contract may involve accepting (if long) or delivering (if short) the asset on which the futures price is based.

*Futures market.* A market in which contracts are traded for future delivery of commodities, currencies, and financial instruments. The purchase or sale of a futures contract requires that a deposit, called margin, be maintained with a broker. The market is designed in such a way that it is easy to get out of a contract or cancel. The vast majority of participants, the buyers and sellers of futures contracts, do not intend to take delivery or deliver what they bought or sold. Futures contracts are used as an investment vehicle and as a vehicle for hedging positions.

*G-10 countries.* The informal term for the

Group of 10 countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, the United Kingdom, and the United States. Switzerland joined in 1984, but the name remains as is.

**Gap.** The period, in foreign-exchange transactions, between the maturities for purchases and those for sales of each foreign currency (exchange gap). In money market transactions, the period between the maturities of placements (loans) and the maturities of borrowing (deposits) of each currency (money market gap). The former occurs when a currency is purchased against one currency and sold against another, each time for different maturities. The money market gap is created by lending an amount of a certain currency for a longer or shorter period than that for which the same currency is borrowed.

**Global bond.** A temporary debt certificate issued by a Eurobond borrower, representing the borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

**Global line.** A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis. See also *Multicurrency line*.

**Gray market.** A forward market for newly issued bonds that takes the form of forward contracting between market participants during the period between the announcement day of a new issue and the day final terms of the bond issue are signed. Bonds are traded at prices stated at a discount of premium to the issue price.

**Group of Eight (G-8).** A group of industrialized countries comprising Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States.

**Guidance line.** An authorization, unknown to the customer, for a line of credit. If communicated to the customer, the guidance line becomes an advised line of credit commitment.

**Hard currency.** The term "hard currency" is a carryover from the days when sound currency was freely convertible into "hard" metal, that is, gold. It is used today to describe a currency that is sufficiently sound so that it is generally accepted internationally at face value.

**Hedging.** A transaction used by dealers in foreign exchange, commodities, or securities, as well as manufacturers and other producers, to protect against severe fluctuations in exchange rates and prices. A current sale or purchase is offset by contracting to purchase or sell at a

specified future date. The object is to defer a profit or loss on the current purchase or sale by realizing a profit or loss on a future purchase or sale. The hedge contract may run for a period that coincides with the expected liquidation of the asset or it may merely last for one, three, six, or twelve months to offset the exchange risk for an asset that is expected to be held for a long term, in which case the choice of the term of the hedge is a matter of relative cost and judgment. Also referred to as "covering."

**Host currency.** See *Local currency*.

**Hot money.** Funds temporarily transferred to a financial center and subject to withdrawal at any moment.

**ICERC.** See *Interagency Country Exposure Review Committee*.

**Impact loan.** A loan specifically designated by a government as important for the development of the country. It usually involves production for export. The term is most often used in regard to Japanese loans.

**Implied forward rate.** The rate of interest at which a borrowing or a lending transaction of a shorter maturity may be rolled over to yield an equivalent interest rate with a borrowing or a lending transaction of longer maturity.

**Indirect quote.** Quotation of a fixed unit of the local currency in variable units of foreign currencies.

**Ineligible acceptance.** An acceptance that does not meet the Federal Reserve eligibility requirements for use at the discount window.

**In the money.** A term used to refer to a call option whose strike price is below or a put option whose strike price is above the current price of the asset on which the option is written.

**Initial margin.** The minimum deposit a futures exchange requires from customers for any futures contract in which a customer has a net long or short position.

**Interagency Country Exposure Review Committee (ICERC).** A nine-member joint committee of three federal regulatory agencies established to administer the country risk supervision program. ICERC centralizes decision making for determinations about the creditworthiness of individual countries.

**Interbank offered rate (IBOR).** The rate at which banks will lend to other banks for a particular currency at a particular location.

**Interest arbitrage.** Involves the movement of short-term funds from one currency to another for the purpose of investing idle funds at a higher yield. However, the real yield advantage

in this situation is not merely the difference in interest rates between the two investment choices, but rather the difference in subtracting the cost of transferring funds into the desired currency and back again from the interest differential. There are four types of interest arbitrage: (1) covered interest arbitrage (transfer of short-term funds into a foreign currency for the sake of a higher yield, with the exchange risk covered), (2) inward interest arbitrage (transfer of short-term funds into local currency for a higher yield), (3) outward interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield), and (4) uncovered interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield, without covering the exchange risk).

*Interest negative.* The commission charged on foreign deposits on which no interest is allowed.

*Interest parities.* Differences at a given time between interest rates charged in two financial centers on short-term credits, investments, or time deposits of identical maturities.

*Interest rate.* The amount (generally expressed as a per annum percentage) of money charged for allowing another party the use of one's money.

*Interest-rate cap.* A transaction whereby a bank pays a fee up-front and will later receive payments if a designated interest rate exceeds a minimum threshold established in the contract. If during the contract, interest rates do not exceed the threshold, the bank loses the initial fee paid. By contrast, if interest rates exceed the threshold, a bank will receive progressively higher payments to offset higher interest expense. The payment received represents the difference between the designated rate and the threshold.

*Interest-rate collar.* The collar combines an interest-rate cap and a floor. A bank buys a cap and pays a fee, which protects the institution should interest rates exceed a stated threshold. The bank simultaneously sells a floor and receives a fee to offset the cost of the cap. The collar establishes a band of interest rates for liabilities—rates cannot exceed the cap's ceiling or the floor's minimum.

*Interest-rate differential.* The difference between the interest rates on two different currencies. Also the swap rate between two currencies expressed as a per annum percentage premium or discount.

*Interest-rate floor.* The floor obligates a seller to pay funds to the buyer if a specified interest

rate falls below a strike rate.

*Interest-rate futures.* Interest-rate futures contracts offer a vehicle through which banks can shift interest-rate risk to the market for financial futures. Interest-rate futures are analogous to futures contracts on commodities. See also *Futures market*.

*Interest-rate swap.* A contractual obligation entered into by two parties to deliver a fixed sum of money against a variable sum of money at periodic intervals. It typically involves an exchange of payments on fixed- and floating-rate debt. If the sums involved are in different currencies, the swap is simultaneously an interest-rate swap and a currency swap.

*International Banking Act of 1978 (IBA).* The principal legislation pertaining to the activities of foreign banks in the United States. It established a policy of national treatment of foreign banks with regard to their operations in the United States.

*International banking facility (IBF).* A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency of a foreign bank, or an Edge Act or agreement corporation. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. IBFs may receive certain tax advantages from individual states.

*International Center for Settlement of Investment Disputes (ICSID).* See *World Bank*.

*International Lending Supervision Act (ILSA).* Enacted in 1983, the act requires U.S. banking agencies to consult with bank supervisory authorities in other countries to achieve consistent policies and practices in international lending.

*International Monetary Fund (IMF).* A specialized agency of the United Nations, the IMF encourages monetary cooperation, promotes stable exchange policy, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. Its resources come mainly from subscriptions of members.

*International Money Market of the Chicago Mercantile Exchange (IMM).* The IMM is one of the world's largest markets for foreign-currency and Eurodollar futures trading.

*International Swap Derivatives Association*

(ISDA). A trade association for derivative contracts.

**Intervention.** The actions of a central bank designed to influence the foreign-exchange rate of its currency. The bank can use its exchange reserves to buy its currency if it is under too much downward pressure or to sell its currency if it is under too much upward pressure.

**Intracountry foreign-currency exposure.** The risk that exists whenever a subsidiary or a branch lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different from that of the country where the borrower and the booking unit are located.

**Intraday position.** The size of spot and forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the date. Sometimes also called “daylight” limits.

**Intrinsic value.** The amount, if any, by which the current market price of the underlying instrument is above the exercise price for calls and below the exercise price for puts.

**Issue price.** The price at which a new issue of securities is placed on sale.

**Joint venture.** The participation of two or more entities in a single business activity. Used to facilitate entry into a market in which other forms of operation may be proscribed.

**Last trading date.** The final day on a futures or options exchange when trading may occur in a given futures contract month or in a given option series.

**Latin American Free Trade Association (LAFTA).** Originally developed to create a common market in Latin America among member countries, it has since been reorganized into the Latin American Integration Association (ALADI). Members include Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela.

**Lead manager.** The commercial or investment bank with the primary responsibility for organizing a syndicated bank credit or bond issue. This includes the recruitment of additional lending or underwriting banks, the negotiation of terms with the borrower, and the assessment of market conditions.

**Lending margin.** The fixed percentage above the reference rate paid by a borrower in a rollover credit or on a floating-rate note.

**Letter of credit—advised.** An export letter of credit issued by a bank that requests another bank to advise the beneficiary that the credit has

been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of the advising bank. The advising bank is potentially liable only for its own error in making the notification.

**Letter of credit—back-to-back.** A letter of credit issued on the strength (or “backing”) of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the United States is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC’s order unless it receives prepayment for the goods, either through cash or some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company. If ABC’s bank agrees, the domestic credit is then “backed” by the foreign letter of credit and a back-to-back letter-of-credit transaction exists.

**Letter of credit—cash.** A letter addressed from one bank to one or more of its correspondents that makes available to a party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

**Letter of credit—commercial.** A letter addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

- **Confirmed irrevocable letter of credit**—A letter in which a bank in addition to the issuing bank is responsible for payment.
- **Irrevocable letter of credit**—A letter in which the issuing bank waives all right to cancel or in any way amend without consent of the beneficiary or seller.
- **Revocable letter of credit**—A letter in which the issuing bank reserves the right to cancel or amend that portion of the amount that has not been demanded before the actual payment or negotiation of drafts drawn.
- **Revolving credit**—A letter in which the issuing bank notifies a seller of merchandise that the amount of credit when used will again

become available, usually under the same terms and without the issuance of another letter.

• *Special clauses*—

— *Green clause*—Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.

— *Red clause*—A clause permitting the beneficiary to obtain payment in advance of shipment so that the seller may procure the goods to be shipped.

— *Telegraphic transfer clause*—A clause in which the issuing bank agrees to pay the invoice amount to the order of the negotiating bank upon receipt of an authenticated cablegram from the latter that the required documents have been received and are being forwarded.

*Letter of credit—confirmed.* A letter of credit issued by the local bank of the importer and to which a bank, usually in the country of the exporter, has added its commitment to honor drafts and documents presented in accordance with the terms of the credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refuses to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) may ask that the letter of credit be confirmed by another bank when the seller is not familiar with the foreign issuing bank or as a precaution against unfavorable exchange regulations, foreign-currency shortages, political upheavals, or other situations.

*Letter of credit—deferred payment.* A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents.

*Letter of credit—export.* A letter of credit opened by a bank, arising from the financing of exports from a country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and, if advised, it becomes an advised (unconfirmed) letter of credit.

*Letter of credit—guaranteed.* A letter of credit guaranteed by the customer (applicant) and often backed by collateral security. In domestic banks, the payment of drafts drawn under this credit is recorded in the general-ledger asset account "Customer Liability—Drafts Paid Under

Guaranteed L/C."

*Letter of credit—import.* A letter of credit issued by a bank on behalf of a customer who is importing merchandise into a country. Issuance of an import credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

*Letter of credit—irrevocable.* A letter of credit that cannot be modified or revoked without the customer's consent or that cannot be modified or revoked without the beneficiary's consent.

*Letter of credit—negotiation.* A letter of credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers, or bona fide holders.

*Letter of credit—nontransferable.* A letter of credit that the beneficiary is not allowed to transfer in whole or in part to any party.

*Letter of credit—reimbursement.* A letter of credit issued by one bank and payable at a second bank that, in turn, draws on a third bank for reimbursement of the second bank's payment to the beneficiary. Those credits are generally expressed in a currency other than that of the buyer (issuing bank) or the seller, and, because of wide acceptability, many are settled in the United States through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

*Letter of credit—revocable.* A letter of credit that can be modified or revoked by the issuing bank up until the time payment is made.

*Letter of credit—revolving.* A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

*Letter of credit—standby.* A letter of credit or similar arrangement, however named or described, that represents an obligation to the beneficiary on the part of the issuer—

- to repay money borrowed by or advanced to or for the account party,
- to make payment on account of any indebtedness undertaken by the account party, or
- to make payment on account of any default by the account party in the performance of an obligation.

*Letter of credit—straight.* A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement

clause to honor drafts is in favor of the beneficiary only.

*Letter of credit—transferable.* A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part, but may only be transferred once.

*Letter of credit—traveler's.* A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

*Letter of credit—usance.* A letter of credit that calls for payment against time drafts, drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

*London Interbank Offered Rate (LIBOR).* The rate at which, theoretically, banks in London place Eurocurrencies/Eurodollars with each other.

*London International Financial Futures Exchange (LIFFE).* A London exchange where foreign-currency and Eurodollar futures, as well as foreign-currency options, are traded on spot exchange. LIFFE was taken over by Euronext in 2002 and subsequently merged with the New York Stock Exchange in 2007.

*Limits (bank customer—foreign-exchange and interbank).* Maximum line amounts allowed with other banks for forward exchange transactions, Eurocurrency and Eurodollar transactions, and payments arising from foreign-exchange transactions on the same day.

*Listing.* The formal process required to have a security regularly quoted on an exchange. Eurobonds are usually listed so that they can be purchased by those institutional investors who are constrained to invest in listed securities.

*Local-currency exposure.* The amount of assets and non-balance-sheet items that are denominated in the local currency of that country.

*Lock-up.* The term used to refer to procedures followed in a Eurobond issue to prevent the sale

of securities to U.S. investors during the period of initial distribution.

*Long position.* An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sale contracts) in the same currency. A dealer's position when the net purchases and net sales leave him or her in a net-purchased position.

*Loro accounts.* Current accounts banks hold with foreign banks in a foreign currency on behalf of their customers.

*Maintenance margin.* The minimum equity a futures exchange requires in a customer's account for each futures contract subsequent to deposit of the initial margin.

*Managed float.* See *Dirty float*.

*Management fee.* The fee received by lead banks as compensation for managing a large-syndicate financing.

*Manager of participation.* The original lender of any loan in which participations are later sold and who generally has a fiduciary relationship with the other lenders. See also *Agent bank*.

*Manager of syndicate.* The bank that solicits the loan from the borrower and solicits other lenders to join the syndicate making the loan.

*Margin.* The amount of money and/or securities that must be posted as a security bond to ensure performance on a contract.

*Marine insurance.* Insurance for losses arising from specified marine casualties. Marine insurance is more extensive than other types as it may provide not merely for losses arising from fire, but also from piracy, wrecks, and most injuries sustained at sea.

- *Average*—A term in marine insurance signifying loss or damage to merchandise.
- *General average*—A loss arising from a voluntary sacrifice of any portion of a shipment or cargo to prevent loss of the whole and for the benefit of all persons at interest. The value of this loss is apportioned not only among all the shippers, including those whose property is lost, but also to the vessel itself. Until the assessment is paid, a lien lies against the whole cargo.
- *Particular average*—A partial loss or damage of merchandise caused by a peril insured against and that does not constitute a general average loss.
- *Free of particular average (F.P.A.)*—Insurance against partial loss regardless of the percentage of the loss.
- *Casco insurance*—Marine insurance on the ship itself (hull) that is usually purchased by

the owners.

- *Cover note*—English equivalent of American binder.
- *Open policy*—A contract between an insurance company and a shipper by which all shipments made by the insured are automatically protected from the time the merchandise leaves the initial shipping point until delivery at destination.

*Mark-to-market.* The revaluation of a traded asset or commodity to reflect the most recently available market price.

*Market-maker.* A bank or other financial institution that gives two-sided (bid and offer) quotations. A market-maker stands prepared to do business on either side of the market without knowing if the inquiring institution intends to buy or sell.

*Market order.* An order that is to be executed immediately at the best available price in the market.

*Matched.* A forward purchase is matched when it is offset by a forward sale for the same date or vice versa. As a necessity, however, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semimonthly period.

*Maturity date.* The settlement date or delivery date for a forward contract.

*Medium-term notes.* Intermediate-term notes that carry a maturity between nine months and ten years.

*Merchant bank.* A European form of an investment bank.

*Money market.* A wholesale market for low-risk, highly liquid, short-term debt instruments.

*Multicurrency line.* A line of credit that gives the borrower the option of using any of the readily available major currencies.

*Multilateral exchange contract.* An exchange contract involving two foreign currencies against each other, for example, a contract for U.S. dollars against Swiss francs made in London or a contract for British pounds against Japanese yen made in New York. Also called an arbitrage exchange contract.

*Multinational bank.* A commercial bank engaged in selling services or conducting operations in more than one country.

*Nationalization.* The act whereby a central government assumes ownership and operation of private enterprises within its territory.

*Negative interest.* A fee charged by a bank for accepting a deposit from a customer. This can

happen when a currency is under pressure to appreciate. A central bank in this situation can establish capital-import controls and limit the amount of deposits that a bank can receive from nonresidents. If market participants want to deposit more money in the country than the central bank will allow, interest rates will drop initially to zero and, if the pressure continues, produce negative interest. Any taxes that a central bank may impose on foreign deposits can also create negative interest.

*Negative pledge.* A contractual promise by a borrower in a syndicated loan or a bond issue not to undertake some future action. One typical negative pledge is that future new creditors will not be given rights greater than those of existing creditors.

*Negotiable instruments.* Written orders or promises to pay that may be transferred by endorsement or delivery, for example, by checks, bills of exchange, drafts, and promissory notes. Governed by article 3 of the Uniform Commercial Code.

*Negotiate.* (1) Letters of credit—To verify that the documents presented under a letter of credit conform to requirements and then, if the documents are in order, to pay the seller of the goods. (2) Negotiable instruments—To transfer possession of an instrument by a person other than the issuer to another person who thereby becomes its holder.

*Net accessible interest differential.* The difference between the interest rates that can actually be obtained on two currencies. This difference is usually the basis of the swap rate between the two currencies and, in most cases, is derived from external interest rates rather than domestic ones. These external rates, or Euro-rates, are free from reserve requirements (which would increase the interest rate) and from exchange controls (which would limit access to the money).

*Net exchange position.* An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

*Net position.* A bank has a net position in a foreign currency when its assets (including future contracts to purchase) and liabilities (including future contracts to sell) in that currency are not equal. An excess of assets over liabilities, including future contracts, is called a net “long” position, and liabilities in excess of assets result in a net “short” position. A net long position in a currency that is depreciating results in a loss because, with each day, the position is convert-

ible into fewer units of local currency. A net short position in a currency that is appreciating represents a loss because, with each day, satisfaction of the position costs more units of local currency.

*Netting arrangement.* Agreement by two counterparties to examine all contracts settling in the same currency on the same day and to agree to exchange only the net currency amounts. Also applies to net market values of several contracts.

*Nominal interest rate.* The interest rate stated as a percentage of the face value of a loan. Depending on the frequency of interest collection over the life of the loan, the nominal rate may differ from the effective interest rate.

*Nonrevolving.* A line of credit that cannot be reused once it has been drawn down to a specified amount.

*Nostro accounts.* Demand accounts of banks with their correspondents in foreign countries in the currency of that country. These accounts are used to make and receive payments in foreign currencies for a bank's customers and to settle maturing foreign-exchange contracts. Also called due from foreign bank—demand accounts, our balances with them, or due from balances.

*Novation.* The substitution of a new party for one of the original parties to a contract. The result is a new contract with the same terms, but at least one new party.

*Odd dates.* Deals within the market are usually for spot, one month, two months, three months, or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

*Offer rate.* The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

*Offering circular.* A document giving a description of a new securities issue, as well as a description of the entity making the issue.

*Office of Foreign Asset Control (OFAC).* An office within the U.S. Treasury Department that administers U.S. laws imposing economic sanctions against targeted hostile foreign countries. While OFAC is responsible for administration of these statutes, all of the bank regulatory agencies cooperate in ensuring compliance.

*Official rate.* The rate established by a country at which it permits conversion of its currency into that of other countries.

*Offshore branch.* Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

*Offshore dollars.* The same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the United States, including Europe.

*Open contracts (open positions).* The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions. See also *Net position*.

*Open interest.* The total number of futures contracts for a particular asset that have not been liquidated by an offsetting trade or that have not been fulfilled by delivery.

*Open market operations.* Purchases or sales of securities or other assets by a central bank on the open market.

*Open position limit.* A limit placed on the size of the open position in each currency to manage off-balance-sheet items.

*Opening bank.* The bank that draws up and opens the letter of credit and that makes payment according to the conditions stipulated.

*Option contract.* A contract giving the purchaser the right, but not the obligation, to buy (call option) or sell (put option) an asset at a stated price (strike or exercise price) on a stated date (European option) or at any time before a stated date (American option).

*Organisation for Economic Co-operation and Development (OECD).* Founded as a successor organization to the Organization for European Economic Cooperation (OEEC). The OEEC was originally established to administer aid under the Marshall Plan during the post-World War II period. The goals of the successor OECD are to stimulate world trade, economic growth, and economic development. Members include Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

*Organization of American States (OAS).* An

organization of 35 independent states of the Americas formed to promote intergovernmental cooperation in the Western Hemisphere.

*Organization of the Petroleum Exporting Countries (OPEC).* A federation of oil-exporting countries that sets petroleum prices for member countries. Members include Algeria, Angola, Ecuador, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.

*Out-of-the-money.* A term used to refer to a call option whose strike price is above or to a put option whose strike price is below the current price of the asset on which the option is written.

*Outright.* Forward exchange bought and sold independently from a simultaneous sale or purchase of spot exchange.

*Outright forward rate.* A forward exchange rate that is expressed in terms of the actual price of one currency against another, rather than, as is customary, by the swap rate. The outright forward rate can be calculated by adding the swap premium to the spot rate or by subtracting the swap discount from the spot rate.

*Overbought.* The position of a trader who has bought a larger amount of a commodity or asset than he or she has sold.

*Overnight.* A swap transaction involving same-day settlement of the spot transaction against a value date of the next business day on the forward contract.

*Overnight position.* A foreign-exchange or money market position maintained overnight. There is more risk involved in this position than in one maintained during the day because political and economic events may take place at night when the operator cannot react immediately to them.

*Override limit.* The total amount of money (measured in terms of a bank's domestic currency) that the bank is willing to commit to all foreign-exchange net positions.

*Oversold.* The position of a trader who has sold a larger amount of a certain asset or commodity than he or she has bought.

*Over-the-counter (OTC).* Transactions not conducted in an organized exchange. OTC markets have no fixed location or listing of products.

*Paris Club.* An ad hoc group of western creditor governments that meets informally under the chairmanship of the French Treasury. Its function is to start the process of rescheduling a country's official debt.

*Parity.* A term derived from par, meaning the equivalent price for a certain currency or security relative to another currency or security, or relative to another market for the currency or security after making adjustments for exchange rates, loss of interest, and other factors.

*Parity grid.* The system of fixed bilateral par values in the European Monetary System. The central banks of the countries whose currencies are involved in an exchange rate are supposed to intervene in the foreign-exchange market to maintain market rates within a set range defined by an upper and a lower band around the par value.

*Participation.* The act of taking part in a syndicated credit or a bond issue.

*Par value.* The official parity value of a currency relative to the dollar, gold, Special Drawing Rights, or another currency.

*Paying agent.* A bank or syndicate of banks responsible for paying the interest and principal of a bond issue to bondholders on behalf of the bond issuer.

*Performance bond.* A bond supplied by one party to protect another against loss in the event of the default of an existing contract.

*Placement memorandum.* A document in a syndicated Eurocredit that sets out details of the proposed loan and gives information about the borrower.

*Political risk.* Political changes or trends, often accompanied by shifts in economic policy, that may affect the availability of foreign exchange to finance private or public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions, as well as the possibilities of war, revolution, or expropriation in each country with which the bank transacts business, regardless of the actual currencies involved. See also *Country Risk*.

*Portfolio investment.* An investment in an organization, other than a subsidiary or joint venture, in which less than 20 percent of the voting shares are held.

*Position.* A situation created through foreign-exchange contracts or money market contracts in which changes in exchange rates or interest rates could create profits or losses for the operator.

*Position book.* A detailed, ongoing record of

an institution's dealings in a particular foreign currency or money market instrument.

*Position risk.* See *Net position*.

*Position-trader.* A speculator in the futures market who takes a position in the market for a period of time.

*Premium.* The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote \$2.00 and \$2.05 (bid and asked) for sterling, and the premiums for six months forward are 0.0275 and 0.0300, the forward quotes would be adjusted to \$2.0275 and \$2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. However, in periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

*Price quotation system.* A method of giving exchange rates in which a certain specified amount of a foreign currency (1 or 100, usually) is stated as the corresponding amount in local currency.

*Primary dealers.* Securities firms that are recognized by the Federal Reserve System to buy and sell securities with the Fed.

*Private placement.* The process of negotiating for the sale of securities, debt, equity, or a combination thereof to a relatively small group of investors.

*Protest.* The formal legal process of demanding payment of a negotiable item from the maker or drawee who has refused to pay.

*Public Law (P.L.) 480.* The most common reference to the Agricultural Trade Development and Assistance Act of 1954. Generally, P.L. 480 authorizes the President to provide various types of assistance to American agricultural exporters, such as making sales in the currency of the destination country.

*Put.* The ability of the bank to require repayment of the debt of a borrower by a third party because of nonperformance of the borrower through an agreement other than a formal guarantee.

*Put option.* A contract giving the purchaser the right, but not the obligation, to sell a particular asset at a stated strike price on or before a stated date.

*Rate risk.* In the money market, the chance that interest rates may rise when an operator has a negative money market gap (a short position) or that interest rates may go down when the operator has a positive money market gap (a long position). In the exchange market, the

chance that the spot rate may rise when the trader has a net oversold position (a short position), or that the spot rate may go down when the operator has a net overbought position (a long position).

*Rate swap.* A transaction in which one participant pays a fixed rate of interest on a notional amount for a given period of time and the other pays a floating rate.

*Reciprocal rate.* The price of one currency in terms of a second currency, when the price of the second currency is given in terms of the first.

*Recourse.* The ability to pursue judgment for a default on a negotiable instrument against parties who signed the note.

*Representations.* Statements made by a borrower in a syndicated credit or bond issue describing the borrower's financial condition.

*Representative office.* A facility established in U.S. or foreign markets by a bank to sell its services and assist clients; in the United States, these offices cannot accept deposits or make loans.

*Repurchase agreement (repo or RP).* A holder of assets sells those assets to an investor with an agreement to repurchase them at a fixed price on a fixed date. The security "buyer" in effect lends the "seller" money for the period of the agreement, and the terms of the agreement are structured to compensate the buyer for this. Dealers use repo extensively to finance their positions.

*Reserve account.* Those items in the balance of payments that measure changes in the central bank's holdings of foreign assets (such as gold, convertible securities, or Special Drawing Rights).

*Reserve currency.* A foreign currency held by a central bank (or exchange authority) for the purposes of exchange intervention or the settlement of intergovernmental claims.

*Reserve requirements.* Obligations imposed on commercial banks to maintain a certain percentage of deposits with the central bank or in the form of central-bank liabilities.

*Retiming.* Restructuring of the timing of interest payable on bonds.

*Revaluation.* An official act wherein the parity of a currency is adjusted relative to the dollar, gold, Special Drawing Rights, or another currency, resulting in less revalued units relative to those currencies. (See also *Devaluation*.) Also, the periodic computations of the current values (revaluations) of ledger accounts and unmatured future purchase and sales contracts.

*Revolving credit.* A line of bank credit that may be used at the borrower's discretion. Interest is paid on the amount of credit actually in use, while a commitment fee is paid on the unused portion.

*Revolving into term.* A commitment that allows a revolving line of credit (usually one to three years) with term provision at the expiration of the revolver for an additional period of time. Most common is a two-year revolver with a five-year, fully amortizing term portion.

*Revolving line of credit.* A line of credit that permits successive drawings and payments at the borrower's discretion. The funds available to the borrower are replenished by any payments of principal.

*Risk-management tools.* Financial devices (such as futures or options) that permit a borrower or lender of funds to protect against the risks of changing currency prices and/or interest rates.

*Risk participation.* An agreement whereby a bank shares the risk in an outstanding credit or instrument. Credit-equivalent amounts of risk participations are assigned based on the risk category appropriate to the account party obligor or, if relevant, to the nature of the collateral or guarantees. Usually treated as a direct credit substitute.

*Rollover.* The process of selling new securities to pay off old ones coming due, refinancing an existing loan, or extending a maturing forward foreign-exchange contract.

*Rollover credit.* A bank loan with an interest rate periodically updated to reflect market interest rates. The interest rate in the loan for each subperiod is specified as the sum of a reference rate and a lending margin.

*Rollover date.* The end of an interest period in a revolving term loan.

*Same-day funds.* Federal funds, or the equivalent, used in the settlement of a transaction that will probably create an interest adjustment of the trading rate to compensate for the difference in the availability of the funds for use.

*Samurai bonds.* Yen-denominated bonds issued by a foreign borrower in Japan.

*Scalpers.* Floor or pit traders in the futures market with short-term horizons who sell slightly above the most recent trade and buy at a price slightly below.

*Seasoned securities.* Securities that have traded in the secondary market for more than 90 days.

*Secondary market.* A market in which secu-

rities are traded following the time of their original issue.

*Selling concession.* The share of total investment-banking fees accruing to the selling group.

*Selling group.* All banks involved in selling or marketing a new issue of bonds. Sometimes the term is used in reference to dealers acting only as sellers and is intended to exclude reference to underwriters or managers.

*Seller's option contract.* A contract in which the seller has the right to settle a forward contract at his or her option anytime within a specified period. See also *Option contract*.

*Selling rates.* Rates at which dealers are prepared to sell foreign exchange in the market.

*Settlement day.* The day on which the actual transfer of two currencies or the transfer of money for an asset takes place at a previously arranged price.

*Settlement price.* The official daily closing price for a futures or option contract. This price is established and used by a clearinghouse to determine each clearing firm's settlement variation.

*Settlement risk.* The possibility that a seller of foreign exchange or securities, having collected the payment in local currency, may fail to deliver the exchange or securities to the buyer.

*Settlement variation.* The sum of all changes in amount for each of a firm's futures or options positions as calculated from each day's settlement price. This amount is paid to or received from the clearinghouse each day based on the previous day's trading.

*Shell branch.* See *Offshore branch*.

*Shogun bonds.* Foreign bonds issued in Tokyo and denominated in currencies other than the Japanese yen. The usual denomination is the U.S. dollar.

*Short position.* An excess of liabilities (and/or forward sale contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net of purchases and sales leaves the trader in a net-sold or oversold position.

*Sight draft.* A draft payable upon presentation to the drawee or within a brief period thereafter known as "days of grace."

*Society for Worldwide Interbank Financial Telecommunications (SWIFT).* A telecommunications network established by major financial institutions to facilitate messages among SWIFT participants. These messages typically result in

a monetary transaction between institutions. The network is based in Brussels.

*Soft currency.* A currency that is not freely convertible into other currencies.

*Soft loans.* Loans with exceptionally lenient repayment terms, such as low interest, extended amortization, or the right to repay in the currency of the borrower.

*Sole of exchange.* A phrase appearing on a draft to indicate that no duplicate is being presented.

*Sovereign risk.* The risk that the government of a country may interfere with the repayment of debt.

*Space arbitrage.* The buying of a foreign currency in one market and the selling of it for a profit in another market.

*Special Drawing Rights (SDRs).* International paper money created and distributed to governments by the IMF in quantities dictated by special agreements among its member countries. The value of SDRs is determined by the weighted value of a “basket” of major currencies.

*Specially designated nationals.* Persons or entities listed by OFAC. These persons or entities are typically front organizations and are subject to OFAC prohibitions. See also *Blocked account, Office of Foreign Asset Control.*

*Speculation.* The purchase or sale of a trading unit, usually on a forward basis, in hopes of making a profit at a later date. The term is used in the foreign-exchange, commodity, stock, and option markets.

*Spot contract.* A foreign-exchange contract traded in the interbank market in which the value date is two business days from the trade date.

*Spot exchange (or spot currency).* Foreign exchange purchased or sold for immediate delivery and paid for on the day of the delivery. Immediate delivery is usually considered delivery in one to two business days after the conclusion of the transaction. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate revaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity. See also *Futures (or forward) exchange contract.*

*Spot month.* The futures-contract month that is also the current calendar month.

*Spot/next.* In the foreign-exchange market, a term used to describe a swap transaction for value on the spot date with the reverse trans-

action taking place the next working day after the spot date. In the Eurocurrency market, a term used to describe a loan or deposit for value on the spot date with maturity on the next working day after the spot date.

*Spot transaction.* A transaction for spot exchange or currency.

*Spread.* The difference between the bid rate and the offer rate in an exchange-rate quotation or an interest quotation. This difference is not identical with the profit margin because traders seldom buy and sell at their bid and offer rates at the same time. In another sense (for example, Eurodollar loans priced at a mark-up over LIBOR), spread means a mark-up over cost, and, in this context, the spread is identical with the profit margin.

*Square exchange position (or square-off).* To make the inflows of a given currency equal to the outflows of that currency for all maturity dates. This produces a square exchange position in that currency.

*Stabilization.* The efforts by a lead manager in a securities issue to regulate the price at which securities trade in the secondary market, during the period that the securities syndicate is still in existence.

*Sterilization.* Intervention in the foreign-exchange market by a central bank in which the change in the monetary base caused by the foreign-exchange intervention is offset by open market operations involving domestic assets.

*Straight bill of lading.* A bill of lading drawn directly to the consignee and therefore not negotiable. See also *Bill of lading.*

*Strike price.* The price at which an option buyer may purchase (if a call option) or sell (if a put option) the asset upon which the option is written.

*Subscription agreement.* An agreement between a securities issuer and the managing banks that describes the terms and conditions of the issue and the obligation of the parties to the agreement.

*Subscription period.* The time period between the day on which a new securities issue is announced and the day on which the terms of the issue are signed and the securities are formally offered for sale.

*Subsidiary.* Entity in which a bank has a modicum of control. Used to facilitate entry into foreign markets in which other operations are proscribed.

*Sushi bonds.* Dollar-denominated Eurobonds issued by Japanese companies and purchased

primarily by Japanese investors. These bond issues are typically managed by Japanese banks.

*Swap.* The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. The trading of one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures. See also *Swap cost (or profit)*.

*Swap arrangement—reciprocal.* A bilateral agreement between central banks enabling each party to initiate swap transactions up to an agreed limit to gain temporary possession of the other party's currency.

*Swap cost (or profit).* In a swap transaction, the cost or profit related to the temporary movement of funds into another currency and back again. That exchange cost or profit must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign-exchange trader cannot be determined if swap profits or costs are charged to the exchange function rather than allocated to the department whose loans or investments the swap actually funded.

*Swap and deposit.* A combination of swap transactions that enables the borrower to have use of both currencies for the duration of the transaction.

*Swap position.* A situation in which the scheduled inflows of a given currency are equal to the scheduled outflows, but the maturities of those flows are purposely mismatched. The expectation in a swap position is that the swap rate will change and that the gap can be closed at a profit.

*Swap rate.* The difference between the spot exchange rate of a given currency and its forward exchange rate.

*Swap-swap.* A swap transaction involving one forward maturity date against another forward maturity date.

*Swaption.* An option on a swap. It gives the buyer the right, but not the obligation, to enter into an interest-rate swap at a future period of time.

*Syndicate.* A group of banks that acts jointly, on a temporary basis, to loan money in a bank credit (syndicated credit) or to underwrite a new issue of bonds (bond underwriting syndicate).

*Syndicate leader.* See *Manager of syndicate*.

*Syndicate participation.* Usually, a large credit arranged by a group of lenders, each of whom advances a portion of the required funds. It

differs from a participation loan because the banks participate at the outset and are known to the borrower.

*Take-down.* The receipt of the principal of a loan by the borrower.

*Tariff.* A duty or tax on imports that can be either a percentage of cost or a specific amount per unit of import.

*Telegraphic transfer (TT) rate.* The basic rate at which banks buy and sell foreign exchange. Buying rates for mail transfers, foreign-currency drafts, traveler's checks, and similar instruments are all based on the TT rate. The TT rate may be slightly less favorable than other rates because of the time required for collection. Foreign-currency time (usance) drafts also are bought at the TT rate, but interest to maturity is deducted for the time which must elapse until maturity.

*Telex.* Direct communication between two banks or companies and organizations via satellite or underwater cable.

*Tenor.* A term designating payment of a draft as being due at sight, a given number of days after sight, or a given number of days after the date of the draft.

*Term structure.* The level of interest rates on debt instruments of a particular type, viewed as a function of term to maturity. The interest-rate level may rise or fall with increasing maturity.

*Terms of trade.* Relative price levels of goods exported and imported by a country.

*Test key.* A code used in transferring funds by cable or telephone so that the recipient may authenticate the message. A test key generally consists of a series of numbers, including a fixed number for each correspondent bank; a number for the type of currency; a number for the total amount; and, possibly, numbers for the day of the month and day of the week. A single number code indicates whether the total amount is in thousands, hundreds, tens, or digits. To arrive at a test number, the indicated numbers are totaled, and the total amount usually precedes the text of the message.

*Third-country bills.* Banker's acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

*Tied loan.* A loan made by a governmental agency that requires the borrower to spend the proceeds in the lender's country.

*Time draft.* A draft drawn to mature at a fixed time after presentation or acceptance.

*Time value.* The amount by which an option's market value exceeds its intrinsic value.

**Tombstone.** In a syndicated credit, an advertisement placed in a newspaper or magazine by banks to record their participation in the loan or, in a bond issue, to record their role in managing, underwriting, or placing the bonds.

**Tomorrow next (tom/next).** The simultaneous purchase and sale of a currency for receipt and payment on the next and second business day, respectively, or vice versa.

**Tradable amount.** The minimum amount accepted by a foreign-exchange broker for the interbank market, for example, 100,000 Canadian dollars or 50,000 pounds sterling.

**Trade acceptance.** A draft drawn by the seller (drawer) on the buyer (drawee) and accepted by the buyer. Also called a trade bill, customer acceptance, and two-name trade paper. See also *Acceptance*.

**Trade accounts.** Those parts of the balance of payments that reflect money spent abroad by the citizens of a country on goods and services and the money spent by foreigners in the given country for goods and services.

**Trader's (or dealer's) ticket (slip).** The handwritten record of a foreign-exchange trade and/or placing and taking of deposits that is written by the dealer who executed the transaction.

**Trading position worksheet.** A record of incomplete transactions in a particular currency.

**Tranche.** One of a number of drawings of funds made by a borrower under a term loan.

**Transaction date.** The date on which a contract's terms are negotiated and agreed on.

**Transfer risk.** The risk arising when a borrower incurs a liability in a currency that is not the currency in which revenues are generated. The borrower may not be able to convert its local currency to service an international loan if foreign exchange is not generated.

**Trending of rates.** Quoting a slightly higher or lower two-way rate in order to reflect a preference for either purchasing or selling.

**Trust receipt.** Used extensively in letter-of-credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee, the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before payment to the issuing bank.

**Two-way quotation.** A simultaneous quotation of foreign-exchange buying and selling rates implying the willingness of the bank to deal either way.

**Two-way rate.** An exchange-rate or an interest-rate quotation that contains both a bid rate and an offer rate. The size of the spread between the two rates indicates the relative quality of the quotation.

**Unconfirmed letter of credit.** See *Letter of credit—advised*.

**Undervalued.** Decline of the spot rate below purchasing power parities, so that the goods of one county are cheaper than in another country. In relation to forward exchange, “undervalued” means that forward premiums are narrower or forward discounts are wider than the interest parities between the two financial centers.

**Underwriting allowance.** The share of total investment-banking fees accruing to the underwriting group.

**Underwriting syndicate.** The banks, in a new securities issue, that agree to pay a minimum price to the borrower even if the securities cannot be sold on the market at a higher price.

**Uniform customs and practices for documentary credits.** Sets of rules governing documentary letters of credit formulated by the International Chamber of Commerce. Includes general provisions, definitions, forms, responsibilities, documents, and the transfer of documentary letters of credit.

**Unmatched.** A forward purchase is unmatched when a forward sale for the same date has not been executed or vice versa.

**Unmatured transactions.** Trading transactions that have not reached their settlement dates.

**Usance.** The period of time between presentation of a draft and its maturity. See also *Tenor*.

**Value-compensated.** The payment or collection of a settlement cost on an open forward contract to cancel the contract rather than to execute an offsetting contract for the same maturity date.

**Value date.** The date on which foreign exchange bought and sold must be delivered and on which the price for the exchange must be paid.

**Value-impaired.** A category assigned by the Interagency Country Exposure Review Committee that indicates a country has protracted debt problems.

**Value today.** An arrangement by which spot exchange must be delivered and paid for on the day of the transaction instead of two business days later.

**Value tomorrow.** An arrangement by which spot exchange must be delivered and paid for on

the business day following the transaction instead of two business days after the transaction.

*Variation margins.* Positive or negative changes in the value of a security bought on margin or a futures contract. These variations must be paid daily in cash. All securities bought or sold on margin and futures contracts are marked to market.

*Volatility.* The standard deviation of changes in the logarithm of an asset price, expressed at a yearly rate. The volatility is a variable that appears in option formulas.

*Volume quotation system.* A method of giving exchange rates in which a certain specified amount of local currency (usually 1 or 100) is stated as the corresponding amount in foreign currency.

*Vostro account.* A demand account maintained for a bank by a correspondent bank in a foreign country. The nostro account of one bank is the vostro account of the other bank. See also *Nostro account*.

*Warehouse receipt.* An instrument that lists and is a receipt for goods or commodities deposited in the warehouse that issues the receipt. These receipts may be negotiable or non-negotiable. A negotiable warehouse receipt is made to the “bearer,” while a nonnegotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral; (2) some or all of the goods may be released against the trust receipt without payment, or (3) a warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouseman. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

*Wash.* A transaction that produces neither profit nor loss.

*Wire.* Often the words “wire” and “cable” are used interchangeably. In some cases, “wire” denotes messages sent within the confines of the United States, and “cable” refers to messages transmitted overseas. Others use “wire” to mean a transfer of funds by telephone rather than by

cable, telex, or telegram.

*Withholding tax.* A tax imposed by a country on the gross amount of payments to a foreign lender from an in-country borrower.

*Within-line facility (or facilities).* Subfacilities of the line of credit that establish parameters, terms, and conditions of various other facilities available for specific additional purposes or transactions. The aggregate sum of all outstandings under within-line facilities must not exceed the total of the overall line of credit.

*World Bank (The International Bank for Reconstruction and Development).* An international financial organization whose purpose is to aid the development of productive facilities in member countries, particularly in developing countries. The chief source of funds is capital contributions made by member countries, which vary with the financial strength of the country. Another funding source is the sale of long-term bonds.

*Writer.* An individual who issues an option and, consequently, has the obligation to sell the asset (if the option is a call) or to buy the asset (if the option is a put) on which the option is written if the option buyer exercises the option.

*Yankee bond.* A dollar-denominated foreign bond issued in the U.S. market.

*Yield curve.* The interest rates for each different tenor or maturity of a financial instrument. A graph of the yield curve has interest rates on the vertical axis and time-to-maturity on the horizontal axis. When longer maturities have higher interest rates than shorter maturities, the curve is called a positive or upward-sloping yield curve. The opposite type of curve is called a negative, downward-sloping, or inverted yield curve. When interest rates are the same for all maturities, the curve is called a flat yield curve. See also *Term structure*.

*Yield to maturity.* The rate of interest on a bond when calculated as that rate of interest which, if applied uniformly to future time periods, sets the discounted value of future bond coupon and principal payments equal to the current market price of the bond.

*Zero coupon bond.* A bond that pays no interest but that is redeemed at its face value at maturity.

Although the methods of international loan portfolio management are similar to those established for domestic lending, the additional risks in international lending require specialized expertise and careful management by the bank. Banks conducting international lending activities should establish strong policies that include not only the basic components found in domestic policies but also the following segments.

*Geographic limits.* The bank should delineate those countries or geographic areas where it can lend profitably and soundly in accordance with its objectives and in consideration of country risks. International lending officers must know the specific country limits established by the board of directors, and the bank should have a monitoring system to ensure adherence to those limits. The limits established will depend on each bank's available financial resources, the qualifications and skills of its staff, the extent of its lending activities, and its further growth potential.

*Distribution by category.* Limitations based on aggregate percentages of total international loans in real estate, consumer credit, ship financing, or other categories are common. Although loan distribution policy may differ among banks, international loans are generally granted in the following categories:

- import and export financing
- loans to corporations or their overseas branches, subsidiaries, or affiliates with a parent guarantee or other form of support
- loans granted to foreign local borrowers including foreign entities of U.S. concerns that borrow without any form of support from the parent corporation
- loans and placements to foreign banks or to overseas branches of U.S. banks
- loans to foreign governments or foreign governmental entities

The categories of credit extensions that the bank's international division should engage in and the nature of any limitations will depend on the particular bank and its customers. Deviations from policy limitations that have been approved by the board of directors or its designated committee(s) should be allowed to meet the changing requirements of the bank's custom-

ers. During times of heavy loan demand in one category, an inflexible loan distribution policy could cause that category to be slighted in favor of another.

*Types of credits.* The lending policy should state the types of international credits that the bank can make and set guidelines to follow in granting specific credits. The decision about the types of credits to be granted should be based on consideration of the expertise of the lending officers, deposit structure of the bank, and anticipated credit needs of its customers. Complex credits requiring more than normal policing should be avoided unless or until the bank obtains the necessary personnel to administer those credits properly. Types of credit that have resulted in an abnormal loss to the bank's international division should be controlled or avoided within the framework of stated policy. Syndications and other types of term loans should be limited to a given percentage of the bank's stable funds.

*Maximum maturities.* International credits should be granted with realistic repayment plans. Maturity scheduling should be related to the anticipated source of repayment, the purpose of the credit, the useful life of the collateral, and the degree of country risk. For term loans, a lending policy should state the maximum number of months during which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modifications to the original terms of a loan. If the bank requires a cleanup (out-of-debt) period for lines of credit, that period should be explicitly stated.

*Loan pricing.* Interest rates, fees, commissions, and discounts on various loan types established by the loan policy must be sufficient to cover the costs of funds loaned, servicing of the loan (including general overhead), and probable losses, while providing for a reasonable rate of return. Periodic review allows the rates to be adjusted to account for changes in costs and competitive factors. Additionally, the bank must establish practices to ensure a continuous examination of the relationships between loan pricing and the cost of funds.

*Foreign-exchange risks.* Lending policy should include controls that minimize risks for loan

portfolios in one currency funded by borrowings in another. These activities must be identified and should be limited by the bank if—

- a particular foreign government is expected to impose stringent exchange controls;
- the currencies involved are or will be subject to wide exchange-rate fluctuations; or
- political, social, or economic developments are likely to intensify exchange risks.

Multicurrency credit commitments permit borrowers to select from a specific list of currencies the one they prefer to use in each rollover period. The listed currencies, however, may be unavailable or available only at a high cost. The bank should protect itself by stating in the loan agreement that its requirement to provide any of the currencies listed is subject to availability at the time requested by the borrower. For detailed information on foreign-exchange risks, see section 7100, “International—Foreign Exchange.”

*Documentation and collateral.* Trade financing often represents a significant amount of an international division’s lending activity. In this type of financing, the bank deals only in documents, while its customer is responsible for the merchandise under the terms of the sales contract. The bank’s control of documents, especially title documents, is crucial. Lending officers and applicable personnel, therefore, must be knowledgeable in handling documentation, which may be the bank’s ultimate support for certain transactions.

The bank must establish policies for taking overseas collateral as security for a loan to ensure that local required procedures are met. For example, in many countries, liens on fixed assets must be registered with the local government, depending on the type of asset. Lending against current assets also requires special care and monitoring. The bank must know which countries do not recognize the legality of trust receipts as recognized in the United States. In other countries, borrowers sign powers of attorney or similar documents permitting lenders to take specifically defined collateral at any time. For these and other reasons, the bank must retain local lawyers who are thoroughly familiar with that country’s laws, regulations, and practices and who will check loan agreements, guarantees, debt instruments, drafts, corporate resolutions, and other loan documentation. There are

significant differences between loan agreements drawn in the United States and those drawn abroad. Nevertheless, the bank must ensure that its loan agreements with borrowers protect it adequately. Generally, few restrictive covenants are required for international loans because of competition in offshore markets and differing local practices. Nevertheless, the bank should insist on protective covenants when appropriate, especially if the borrowers are small or medium-sized obligors. The bank also should ensure that loan agreements provide for the borrower to reimburse the lender for certain unanticipated costs, including the imposition of taxes on interest withheld at the source without corresponding credits gained on the levy of U.S. taxes and the need to establish or increase bad debt reserves.

*Financial information.* Current and complete financial information is necessary at the inception and throughout the term of an international loan. The lending policy should specifically define financial-statement requirements for businesses, foreign banks, foreign governments, other foreign public-sector entities, and individuals, and it should include criteria for the requirement of audited, nonaudited, fiscal, interim, operating, cash-flow, and other statements. The requirements should be defined clearly enough so that any credit data exception in the examination report is a clear exception to the bank’s lending policy.

The reliability of financial statements and accompanying information differs greatly among countries. In some countries, accounting standards and traditions are lax and audited statements are virtually unknown. Financial information provided for tax-collection purposes in foreign countries may differ from that given in confidence to the bank to obtain credit.

In analyzing financial statements of foreign entities, factors are present that do not exist when analyzing those of U.S. enterprises, such as markedly different accounting concepts, the wide use of “hidden reserves,” translation problems, different methods of valuing assets, or unfamiliar and sharply different legal principles. A general rule in analyzing local currency statements is not to translate figures to U.S. dollar equivalents. Fluctuating exchange rates can have a significant impact on the analysis of U.S. dollar equivalents over a period of time. If a loan is to be repaid in currency other than the borrower’s domestic currency, an analysis of

probable future foreign-exchange-rate movements is necessary to assess the borrower's ability to generate sufficient local currency to buy the necessary exchange. An analysis of the availability of exchange is also required to ensure full repayment at maturity. Financial Accounting Standards Board Statement No. 52, "Foreign-Currency Translation," takes certain translation adjustments out of earnings and places them in a separate component of equity capital ("foreign-currency translation adjustments"), thereby reducing the fluctuations in earnings produced by changing exchange rates. Since the financial information provided is not always reliable, the bank's policies should enable it to determine by other means the capacity, integrity, experience, and reputation of the foreign borrower.

Extensions of credit to foreign banks constitute an important segment of an international division's foreign loans. It is important to obtain information on the nature of the bank's business; its assets, liabilities, and contingent accounts; and its record of past earnings. A review of these data should lead to a determination of the strength of the bank and its ability to meet its obligations in the foreseeable future. At minimum, this review should include—

- the size and liquidity of primary and secondary reserves;
- the nature of lending activities, including types and terms of loans, extent of collateral held, and loss experience;
- lending policies and controls in effect to ensure compliance with applicable lending laws and regulations;
- the size and character of investments;
- the size of fixed assets;
- the size and nature of investments in subsidiaries and other affiliates and the extent to which the bank will support those entities in times of difficulty;
- the source and nature of deposits and their volatility;
- the nature and extent of other liabilities and contingent liabilities, including standby facilities;
- the earnings and dividend record and the adequacy of capital;
- the activities of the bank in the foreign-exchange and interbank markets;
- the size and character of the bank's international business; and
- the competency of management.

The quality of management is the key to the analysis of foreign banks and is best determined by frequent visits by officers of the lending bank. Credit checks from other lenders should be required with periodic updates. Credit reports are not available in all countries and, when provided, are often incomplete or vague. Consequently, there is no substitute for firsthand information obtained from visits to overseas banks.

*Country risk.* Balance of payments; exchange control; and economic, political, and social information on each borrower's home country should be on file to enable the bank to assess the elements of country risk. The lack of this information is as serious a weakness as the lack of financial information on the borrowers. For additional information, see section 7040, "International—Transfer Risk."

*Limits and guidelines for purchasing loans.* Purchasing loans from dealers or correspondent banks is a common practice in banks with limited opportunities to generate international credit extensions on their own. However, these purchases may restrict a bank to low-profit loans at narrow spreads over a medium-to long-term period. Buying loans seldom builds relationships with borrowers since the relationship generally stays with the bank originating the loan. Therefore, the lending policy should limit the amount of paper purchased from any one outside source and should state an aggregate limit on all these loans.

*Limitation on aggregate outstanding loans.* Limitations on the total amount of loans outstanding relative to other balance-sheet accounts should be established for the bank, with limits (or sublimits) applicable to international loans clearly defined. Controls over the international loan portfolio are usually expressed relative to deposits, capital structure, or total assets.

*Concentration of credits.* The same types of concentrations of credits found in a domestic loan portfolio may exist in the international portfolio. In international banking, however, an additional concentration involves loans to a foreign government, its agencies, and its majority-owned or -controlled entities. Loans to specific private businesses may be included in those concentrations if an interrelationship exists in the form of guarantees, moral commitments,

significant subsidies, or other factors indicating dependence on the government. The bank's directorate should evaluate the risks involved in various concentrations and determine those concentrations that should be avoided or limited. The lending policy should also require that all concentrations in the international division be reviewed and reported frequently. For a full discussion of this component, see section 2050, "Concentrations of Credits."

*Loan authority.* The lending policy should establish written limits for all international lending officers. Lending limits also may be established for group authority, allowing a combination of officers or a committee to approve loans larger than those the members would be permitted to approve individually. The reporting procedures and the frequency of committee meetings should be defined. If the bank operates foreign branches, head office–delegated lending authority should be clearly defined and understood by overseas lending officers.

*Nonperforming credits and charge-offs.* The lending policy should define nonperforming credit extensions of all types (delinquencies, nonaccruals, or reduced rates) and should specify their accounting and reporting requirements. Reports should be submitted regularly to the board of directors and senior management. The management of banks with overseas branches must take extra care to define and communicate their banks' policies and procedures on nonperforming credits to ensure that all bank offices are properly identifying, accounting for, and reporting credits. The reports should include sufficient detail to allow for the determination of risk factors, loss potentials, and alternative courses of action to effect repayment of nonperforming credits. The policy governing delinquent credits should require a follow-up notice procedure that

is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by senior management or the directorate for potential charge-off at a stated period of delinquency.

*Other.* The lending policy should be supplemented with other written guidelines for specific departments concerned with credit extensions, such as letters of credit, banker's acceptances, and discounted trade bills. Written policies and procedures approved and enforced in those departments should be referenced in the general lending policy of the bank.

Before a bank grants international credit, its objectives, policies, and practices must be clearly established. The bank must consider its overall size, financial resources, the nature of its customers, its geographic location, and the qualifications and skills of its staff. An examiner should review policies and practices to determine if they are clearly defined and adequate to monitor the condition of the portfolio. If written guidelines do not exist, there is a major deficiency in the lending area, and the board of directors is not properly discharging its duties and responsibilities. If no exception is taken to the objectives, policies, and practices, the international loan portfolio can then be reviewed to ensure compliance.

The failure of the directors to establish a sound international lending policy, of the management to establish adequate written procedures, or of both to monitor and administer the international lending function within established guidelines has resulted in serious problems for banks. Major sources and causes of loan trouble, as discussed in domestic "Loan Portfolio Management," section 2040, also apply to international lending.

# International—Loan Portfolio Management

## Examination Objectives

Effective date May 1996

## Section 7020.2

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1. To determine if policies, practices, procedures, and internal controls for international loan portfolio management are adequate.
2. To determine if bank officers are operating in conformance with the established bank guidelines.
3. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
4. To determine the overall quality of the international loan portfolio and how that quality affects the soundness of the bank.
5. To prepare information on the bank's lending function in a concise, reportable format.
6. To determine compliance with applicable laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

# International—Loan Portfolio Management

## Examination Procedures

Effective date March 1984

## Section 7020.3

1. If selected for implementation, complete or update the International Loan Portfolio Management section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examining procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
3. Request reports on the following from the bank's international division, by department, as of the examination date unless otherwise specified:
  - a. Past-due loans. This report should cover:
    - Single payment and demand notes past due.
    - Single payment and demand notes on which interest is due and unpaid for 30 days or more.
    - Consumer, mortgage and term loans payable in regular installments on which one installment is due and unpaid for 30 days or more.
    - Outstandings under cancelled advance (overdraft) facilities that are unpaid.
    - Discounted (purchased) outgoing foreign bills matured and unpaid and advances secured by pledged delinquent foreign bills.
    - Unauthorized overdrafts including any resulting from customers not paying the bank for banker's acceptances or drafts it paid.And should include the following information:
    - Name of the obligor.
    - Original amount of the loan.
    - Outstanding balance of the loan.
    - Date the loan was made.
    - Due date.
    - Terms of the loan.
    - Number of payments the loan is delinquent.
    - Date of the borrower's last payment.
    - Date to which interest is paid.For larger international loans, the report should also include:
    - Purpose of the loan.
    - Any action being taken to bring the loan current.
  - b. International loans on which interest is not being collected in accordance with the terms of the loan.
  - c. International loans the terms of which have been modified by a reduction of interest rate or principal payment or by a deferral of interest or principal.
  - d. International loans for which repayment terms have been restructured.
  - e. International loan participations purchased and sold and participations in consortium credits since the previous examination.
  - f. International loans sold in full since the previous examination.
  - g. International credits considered "problem credits" by management (this report may be either as of the examination date or as of the date the report was last submitted to the officer's loan review committee(s), the loan and discount committee(s), or the board of directors).
  - h. International credit commitments and other contingent liabilities.
  - i. Loans secured by stock of other banks and rights, interest, or powers of a savings and loan association.
  - j. Extensions of credit to employees, officers, directors, or their interests.
  - k. Extensions of credit to executive officers, directors, principal shareholders and their interests of correspondent banks.
  - l. Miscellaneous loan debit and credit suspense accounts.
  - m. Current interest rate structure.
  - n. Current lending authorities of officers and credit committee(s).
4. Obtain the following information:
  - a. A copy of written policies covering all international lending functions.
  - b. A statement of whether a standing committee administers the lending function.
  - c. Copies of reports furnished to the board of directors for its meetings.
  - d. Lists of directors, executive officers, principal shareholders and their interests.
  - e. A summary of the officer borrowing report (debts to own and other banks).

- f. A list of previously charged-off loans approved by the directors.
5. Obtain a copy of the latest reports furnished to the international loan and discount committee(s). (The domestic loan and discount committee(s) sometimes handle(s) international loans and discounts.)
6. Review international lending policies and updates and abstract appropriate excerpts on:
  - a. Distribution of loans by category.
  - b. Geographic area and country exposure limitations.
  - c. Type of borrowing and industrial concentration limitations.
  - d. Lending authorities of committees and officers.
  - e. Any prohibited types of international loans.
  - f. Maximum maturities for various types of international loans.
  - g. Interest rate structure.
  - h. Minimum downpayment for various types of loans.
  - i. Collateral appraisal policies including:
    - Persons authorized to perform appraisals.
    - Lending values of various types of assets.
  - j. Financial information requirements by types of loans.
  - k. Guidelines for purchasing other banker's acceptances and commercial paper.
    1. Guidelines for loans to major shareholders, directors, officers, or their interests.
7. When more than one international lending policy exists, determine if they are internally consistent by reviewing the guidelines previously obtained.
8. Review minutes of the bank's international loan and discount committee(s) meetings to obtain:
  - a. Present members and their attendance record.
  - b. Scope of work performed.
  - c. Any information considered useful in the examination of specific loan categories or other areas of the bank.
9. Compare reports furnished to the board of directors and the loan and discount committee(s), and those received from the bank in step 3 to determine any material differences and that the differences are transmitted to the board in a timely manner.
10. Compare the lists of directors, officers and their related interests to determine:
  - a. Preliminary compliance with Regulation O (12 CFR 215) (loans to insiders).
  - b. Preliminary compliance with established policies.
11. Perform the following steps for past-due loans:
  - a. Compare the following to determine any material inconsistencies:
    - The past-due schedule received in step 3. Delinquency reports submitted to the board.
    - List of loans considered "problem" loans by management.
  - b. Scan the delinquency lists submitted to the board of directors and senior management to determine that reports are sufficiently detailed to evaluate risk factors.
  - c. Compile current aggregate totals of past-due paper.
12. Perform the following using the loan commitments and contingent schedules obtained in step 3:
  - a. Reconcile appropriate contingency totals to memoranda ledger controls.
  - b. Review reconciling items for reasonableness.
13. Obtain the listing of Uniform Review of Shared National Credits and update the listing based on information obtained in step 3.
14. Obtain the classifications and categories of strong, moderately strong, and weak countries from Interagency Country Exposure Review Committee meeting for which write-ups have been made available and update that data based on information obtained in step 3.
15. Distribute the applicable schedules and other information obtained in the preceding steps to the examiners performing the loan examination programs. Request that the examiners test the accuracy of the information. Also, request that they perform appropriate steps in the separate program "Concentration of Credits."
16. Determine the general distribution and characteristics of the international loan portfolio by:
  - a. Determining the percentage of total loans in specific classes and geographic areas.
  - b. Comparing international loan category distributions to policy guidelines.

17. Obtain the results of the reviews performed of the various segments of the international division during the course of the examination, and perform the following:
  - a. Determine any nonadherence to internally established policies, practices, procedures, and controls.
  - b. Compare the various international division results to determine the extent of nonadherence and if it is systemwide.
  - c. Organize internal guideline exceptions in order of relative importance.
  - d. Determine the aggregate amount of statutory bad debts.
  - e. Organize violations by law and regulation.
  - f. Review international credit classifications and assets listed for special mention to determine:
    - Inclusion of all necessary information.
    - Substantiation of classification or criticism.
  - g. Determine the aggregate amount of credit extensions listed in each of the four levels of criticism.
  - h. Compile a listing of all credit extensions not supported by current and satisfactory credit information.
  - i. Compile a listing of all credit extensions not supported by complete collateral documentation.
  - j. Review the separate procedures for “Concentration of Credits” and determine:
    - If all necessary data is included.
    - If there is substantiation for including specific items in the report of examination as a concentration.
    - If the concentration is undue or unwarranted.
  - k. Compute the following ratios and compare to computations from prior examinations:
    - Aggregate international division past due paper to international division loans and overdrafts outstanding.
    - Aggregate international division “A” paper to international division past due.
    - Total international division past due, nonaccrual and renegotiated rate credits to total international division credits.
    - Aggregate classified international credits to primary capital funds.
    - Aggregate classified international credit to total bank classified credits.
    - Weighted classified international credits to primary capital funds.
18. Forward the totals of international division loss and doubtful classifications to the examiner assigned to analyze the adequacy of the bank’s capital.
19. Compare management’s list of “problem” credits from step 3 to the examiner’s listing of international classified and criticized credits to determine the extent of management’s knowledge of its own international credit problems.
20. Determine, through an in-depth analysis of information previously generated, the causes of existing problems or weaknesses within the international division’s systems which present potential for future problems.
21. Forward the following information to the examiner assigned to analyze the bank’s loan loss reserves.
  - a. A listing of international division credits considered “problem” credits by management.
  - b. A listing of classified and criticized credits relating to the international division.
  - c. A listing of previously charged-off loans.
22. Organize the results of the examination of the international lending function to facilitate discussion with the examiner-in-charge and, upon approval, with senior management of the bank.
23. During discussion with senior management, structure inquiries in such a manner as to:
  - a. Gain insight into management’s international lending philosophy.
  - b. Elicit management responses for correction of deficiencies.
24. Write, in appropriate report format, general remarks which may include:
  - a. The scope of the examination of the international lending function.
  - b. The quality of internal policies, practices, procedures, and controls over the international lending function.
  - c. The general level of adherence to internal policies, practices, procedures, and controls that govern the bank’s international lending function.
  - d. The scope and adequacy of the internal loan review system regarding international credit extensions.
  - e. The quality of the entire international credit portfolio.

- f. The competency of management with respect to the international lending function.
  - g. Causes of existing credit problems.
  - h. Expectations for continued sound international lending and correction of existing credit control and quality deficiencies.
  - i. Promises made by management for correction of credit control and quality deficiencies.
  - j. Credit extensions to insiders and their interests.
- 25. Compile or prepare all information which provides substantiation for your general remarks.
  - 26. Update the workpapers with any information that will facilitate future examinations.

# International—Loan Portfolio Management

## Internal Control Questionnaire

Effective date June 1985

## Section 7020.4

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

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan portfolio management objectives and policies that:
  - a. Establish suggested guidelines for distribution of international loans by different categories?
  - b. Establish geographic area limits for credits?
  - c. Establish suggested guidelines for aggregate outstanding international loans in relation to other balance sheet categories?
  - d. Establish international loan authority of committees and individual lending officers?
  - e. Define acceptable types of international loans?
  - f. Establish maximum maturities for various types of international loans?
  - g. Establish international loan pricing?
  - h. Establish appraisal policy?
  - i. Establish minimum financial information required at inception of the credits?
  - j. Establish limits and guidelines for purchasing paper?
  - k. Establish guidelines for loans to bank directors, officers, and their related interests?
    - l. Establish collection procedures?
  - m. Define the duties and responsibilities of international loan officers and loan committees?
  - n. Outline international loan portfolio management objectives that acknowledge:
    - Concentrations of credit within specific industries and relating to country credits?
    - The need to employ personnel with specialized knowledge and experience?
    - Possible conflicts of interest?
2. Are international loan portfolio management objectives and policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are the following reported to the board of directors or its designated committees (indicate which) at their regular meetings (at least monthly):
  - a. Past-due single payment loans (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - b. Loans on which interest only is past due (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - c. Term loans on which one installment is past due (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - d. Outstandings under overdraft facilities that are unpaid (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - e. Discounted (purchased) outgoing foreign bills matured and unpaid (or advances collateralized by pledged delinquent foreign bills) (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - f. Overdrafts resulting from a customer not paying the bank for banker's acceptances or drafts the bank paid (if so, indicate minimum days past due for them to be included \_\_\_\_\_)?
  - g. Total outstanding international loan commitments?
  - h. Loans requiring special attention?
  - i. New loans and loan renewals or restructured loans?
4. Are reports submitted to the board or its committees rechecked by a designated person for possible omissions prior to their submission?
5. Are written applications required for all international loans?
6. Does the bank maintain credit files for all international borrowers?
7. Does the credit file contain information on:
  - a. The purpose of the loan?
  - b. The planned repayment schedule?
  - c. The disposition of loan proceeds?

- d. The points to be raised regarding the borrower from which to base questions during officer calling programs?
- e. Lending officer calls on customers and foreign countries?
8. Does the bank require periodic submission of financial statements by all international division borrowers whose loans are not fully secured by readily marketable collateral?
9. Is a tickler file maintained to assure that current financial information is requested and received?
10. Does the bank require submission of certified financial statements based on dollar amount of commitment (if so, state the dollar or equivalent minimum \$\_\_\_\_\_)?
11. Are financial statements of foreign borrowers spread in the credit file by local currency and U.S. dollar equivalents, if appropriate, on a yearly comparative basis?
12. Are borrower financial statements spread with those of comparable borrowers in the same country?
13. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?
14. Does the bank have a periodic lending officer call program for:
  - a. Customers?
  - b. Countries?
15. Is it required that all international loan commitments be in writing?
16. Are international lines of credit reviewed and updated at least annually?
17. Are borrower's outstanding liabilities checked to appropriate lines of credit prior to granting additional advances?
18. Is there an internal review system (it may be a function of the internal audit department) which covers each department and:
  - a. Rechecks interest, discounts, fees, commissions, and maturity date computations?
  - b. Re-examines debt instruments for proper execution, receipt of all required supporting papers, and proper disclosure forms?
  - c. Determines that international loan approvals are within the limits of the bank's lending authorities?
  - d. Determines that international loans outstanding and committed are within the bank's foreign country or foreign currency limits?
- e. Determines that notes and debt instruments are being approved initially by the loan officer?
- f. Ascertains that new international loans are within the limitations set for the borrower by corporate resolution?
- g. Rechecks liability ledgers to determine that new loans have been accurately posted?
- h. Rechecks the preparation of maturity and interest notices?
- i. Examines entries to various general ledger loan controls?
- j. Confirms collateral, loans, and discounts with customers on a test basis?
19. Does the bank have an international loan review section or the equivalent?
20. Is the loan review section independent of the international lending function?
21. Are the initial results of the international loan review process submitted to a person or committee which is also independent of the international lending function?
22. Are all international loans exceeding a certain dollar amount selected for review?
23. Do international lending officers recommend loans for review?
24. Is a method, other than those detailed in steps 23 or 24, used to select international loans for review (if so, provide details)?
25. Are internal reviews conducted at least annually for all international lending areas?
26. In an officer identification system, are guidelines in effect which define the consequences of an officer withholding a loan from the review process?
27. Is the bank's international problem loan list periodically updated by the lending officers?
28. Does the bank maintain a list of international loans reviewed, indicating the date of the review and the credit rating?
29. Does the loan review section prepare summaries to substantiate credit ratings, including pass loans?
30. Are loan review summaries maintained in a central location or in appropriate credit files?
31. Are followup procedures in effect for internally classified international loans, including an update memorandum to the appropriate credit file?
32. Are officers and employees prohibited from holding blank signed notes and other debt

- instruments in anticipation of future borrowings?
33. Are paid and renewed notes cancelled and promptly returned to customers?
  34. Do loan proceeds disbursed in cash require a customer receipt?
  35. Are international loan records retained in accordance with record retention policy and legal requirements?
  36. Are new notes microfilmed daily?
  37. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?
  38. Does the bank maintain loan interest, discount, fee, and commission rate schedules for various types of international loans?
  39. Does the bank periodically update the above rate schedules (if so, state normal frequency \_\_\_\_\_)?
  40. Does the bank maintain records in sufficient detail to generate the following information by type of advance:
    - a. The cost of funds loaned?
    - b. The cost of servicing loans, including overhead?
    - c. The cost factor of probable losses?
    - d. The programmed profit margin?
  41. Does the international division maintain adequate and current country analysis information?
  42. Has the international division conducted studies for those industries in which it is a substantial lender?

## CONCLUSION

43. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
44. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

# International—Loans and Current Account Advances

Effective date May 1996

## Section 7030.1

A bank's international division lends, either directly or through state entities, to U.S. importers and exporters, foreign companies, multinational corporations, foreign banks, and foreign governments. The terms of these lending activities are consistent with the purpose of the financing.

Short-term working-capital loans to commercial business enterprises commonly finance inventories or receivables arising from trade. Receivable pledges, warehouse receipts, and liens on inventory or commodities may be held as collateral. However, in certain countries, these forms of collateral are not legally recognized and, therefore, the banks must be thoroughly familiar with applicable local laws, regulations, and practices. Loans to foreign banks are usually short-term and unsecured.

Medium-term lending (one to five years) generally represents capital goods financing, shipping loans, and various specialized credits. Long-term loans (those exceeding five years) are normally used to finance extensive projects of multinational corporations, foreign governments, or foreign state entities. Government guarantees of private long-term loans are common when the project has significant importance to a national economy.

The methods of loan financing in an international division are the same as those for domestic lending. Loans in the international division may be direct or discounted. In both of these instances, the bank holds a promissory note or similar instrument evidencing indebtedness. Current account advances, however, are a category of loans unique to international banking. This method of financing is an American substitute, used by banks in the United States, for the European method of financing by overdrafts, which is also a common lending method of overseas offices of U.S. banks. Current account advances, like overdrafts, are extensions of credit in which no instrument of specific indebtedness is used; however, a signed agreement is on file stating the conditions applicable to advances made by the bank to the obligor. Other types of

international financing treated as loans include own acceptances purchased (discounted), other banker's acceptances purchased, and discounted trade acceptances.

The same credit risks apply to international division loans as to those made in domestic loan departments, with the addition of country risk, which is the primary additional component that distinguishes an international loan from a domestic loan. Country risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country and from the governmental policies structured to respond to those conditions that may have adverse consequences for the repayment of a foreign borrower's debt. More specifically, there is a risk associated with a borrower's capacity to obtain the foreign exchange required to service its cross-border debt (that is, transfer risk). An obligor may have the financial means in its domestic currency to repay its indebtedness, but nationalization, expropriation, governmental repudiation of external indebtedness, the imposition of exchange controls, or currency devaluation may preclude the lender from obtaining timely repayment. Apart from a nation's outright repudiation of external debt, these developments might not result in an uncollectible extension of credit; however, the delay in collection could adversely affect the condition of the lending bank.

This section is designed to apply to most types of loans and current account advances found in an international division. However, lending areas in many international divisions and overseas branches are often segregated into separate departments and differ substantially from international loans and current account advances. Those are discussed in separate sections of this manual: "International—Financing Foreign Receivables," "International—Banker's Acceptances," "International—Letters of Credit," and "International—Guarantees Issued," sections 7050, 7060, 7080, and 7090, respectively.

# International—Loans and Current Account Advances

## Examination Objectives

Effective date May 1996

Section 7030.2

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1. To determine the adequacy of policies, practices, procedures, and internal controls for international loans and advances.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

# International—Loans and Current Account Advances Examination Procedures

Effective date October 2008

Section 7030.3

1. If selected for implementation, complete or update the international lending section of the internal control questionnaire.
2. Determine the scope of the examination on the basis of the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records.
  - a. Reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination, review the loan and collateral documentation, and prepare credit line cards.
6. Obtain the following information:
  - a. past-due, nonaccrual, and reduced-rate loans and advances
  - b. loans whose terms have been modified by a reduction in interest rate or principal payment or by a deferral of interest or principal
  - c. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination.
  - d. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
  - e. loan commitments and other contingent liabilities
  - f. reports of the indebtedness of executive officers, principal shareholders, and their related interests to correspondent banks
  - g. a list of correspondent banks
  - h. extensions of credit to major stockholders of the bank and to bank employees, officers, and directors, and to their related interests (specify which officers are considered executive officers)
7. Review the information received and perform the following procedures.
  - a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
    - Participations only:
      - Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
      - Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
      - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
    - All transfers:
      - Investigate any situations in which loans were transferred immediately
  - i. miscellaneous loan-debit and credit-suspense accounts
  - j. Interagency Country Exposure Review Committee (ICERC) determinations
  - k. criticized Shared National Credits (applicable international division credits)
  - l. loans considered “problem loans” by management
  - m. specific guidelines in the lending policy
  - n. current lending authorities of bank officers and credit committees
  - o. the current interest-rate lending structure of the bank
  - p. any useful information on international division credit extensions resulting from the review of the minutes of the loan and discount committee(s) and any other credit committee(s)
  - q. reports on international division credit extensions furnished to the loan and discount committee(s) and any other credit committee(s)
  - r. relevant reports furnished to the board of directors
  - s. loans criticized during the previous examination

- before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
- Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
  - Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium). Section 23A of the Federal Reserve Act generally prohibits a state member bank from purchasing a low-quality asset.
  - Determine that low-quality assets transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
  - If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
    - (1) name of originating institution
    - (2) name of receiving institution
    - (3) type of transfer (i.e., participation, purchase or sale, swap)
    - (4) date of transfer
    - (5) total number of loans transferred
    - (6) total dollar amount of loans transferred
    - (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
    - (8) any other information that would be helpful to the other regulator
- b. *Miscellaneous loan-debit and credit-suspense accounts.*
    - Discuss with management any large or old items.
    - Perform additional procedures as considered appropriate.
  - c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability together with the combined amounts of the current loan balance, if any.
  - d. *Loans criticized during the previous examination.* Determine disposition of loans so criticized by transcribing the current balance and payment status or the date the loan was repaid and the source of repayment.
    - Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or as a result of a participation, sale, or swap with another lending institution.
    - If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.
  - e. *Shared National Credits.*
    - Compare the schedule of international loans and current account advances included in the Uniform Review of National Credits program with the bank's reports of international loans outstanding.
    - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.
  - f. *ICERC credits.*
    - Identify any loans that were selected for review that are criticized for transfer-risk reasons by ICERC.
    - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.
8. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
  9. Prepare credit line cards for any international loan not previously selected for review that, on the basis of information derived

- from the above schedules, requires an in-depth review.
10. Obtain customer liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other lending areas, and together decide who will review the borrowing relationship. Pass or retain complete credit line cards.
  11. Prepare collateral line cards for all borrowers selected in the preceding steps.
  12. Obtain credit files for all borrowers for whom examiner credit line cards were prepared, and complete the credit line cards, where appropriate. To analyze the international loans, perform the following procedures:
    - a. Analyze balance sheets and profit-and-loss figures as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends or ratios.
    - b. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure of the borrower.
    - c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate the adequacy of those sources.
    - d. Ascertain compliance with provisions of credit agreements.
    - e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual repayment programs of the borrower's indebtedness.
    - f. Relate collateral values to outstanding debt, and determine when the collateral was last appraised.
    - g. Compare interest rates charged with the current interest-rate schedule of the bank, and determine that the terms are within established guidelines.
    - h. Compare the original amounts of the customer's obligations to the bank with the lending officer's authority.
    - i. Analyze secondary support afforded by guarantors and endorsers.
    - j. Ascertain compliance with the bank's established international loan policy.
  13. For loans selected for review, check the central liability file for borrowers indebted above the cutoff line or for borrowers displaying credit weakness or suspected of having additional liability in other lending areas.
  14. Transcribe significant liability and other information on officers, principals, and affiliations of borrowers selected for review. Cross-reference line cards to borrowers, where appropriate.
  15. Determine the bank's compliance with laws and regulations pertaining to international lending by performing the following steps:
    - a. *Lending limits.*
      - Determine the bank's lending limit as prescribed by state law.
      - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    - b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and the Board's Regulation W.*
      - Obtain a listing of loans to affiliates.
      - Test-check the listing against the bank's customer liability records to determine its accuracy and completeness.
      - Ensure that loans to affiliates do not exceed limits of section 23A and Regulation W.
      - Ensure that loans to affiliates meet the collateral requirements of section 23A and Regulation W.
      - Determine that low-quality assets have not been purchased from an affiliate.
      - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
      - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
    - c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*
      - While examining the international lending function, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.

- Investigate any such suspected instances.
- d. *Federal Election Campaign Act (2 USC 441b), Political Contributions and Loans.*
- While examining the international lending area, determine the existence of any loans in connection with any political campaigns.
  - Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.
- e. *Regulation Y (12 CFR 225.7), Tie-In Provisions.* While reviewing international credit and collateral files, especially loan agreements, determine whether any extension of credit is conditioned upon—
- obtaining or providing any additional credit, property, or service from or to the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
  - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.
- f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows: (The examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment.)
- *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
    - test the accuracy and completeness of information about international loans by comparing it with the trial balance or loans sampled;
    - review credit files on insider loans to determine that required information is available;
    - determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
    - determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
    - determine that loans to insiders do not exceed the lending limits imposed by Regulation O;
    - if prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained;
    - determine compliance with the various reporting requirements for insider loans;
    - determine that the bank has made provisions to comply with the disclosure requirements for insider loans; and
    - determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years after the dates of the requests.
  - *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95-630), as amended by the Garn-St Germain Depository Institutions Act of 1982, Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
    - Obtain from, or request that the examiners reviewing due from banks and deposit accounts verify, a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
    - Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.
- g. *12 USC 1828(v), Loans Secured by Bank Stock.*
- While examining international loans, determine the existence of any loans or discounts that are secured by the insured financial institution's own stock.
  - In each such case, determine that the chief executive officer has promptly

- reported such fact to the proper regulatory authority.
- h. *12 USC 83 (Rev. Stat. 5201), made applicable to state member banks by section 9, paragraph 6, of the Federal Reserve Act (12 USC 324), Loans Secured by Own Stock (see also Federal Reserve Regulatory Service 3–1505):*
- While examining international loans, determine the existence of any loans secured by the bank's own shares or capital notes and debentures.
  - Confer with the examiner assigned investment securities to determine whether the bank owns any of its own shares or its own notes and debentures.
  - In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent a loss on a debt previously contracted (DPC) transaction.
  - In each case of ownership, determine whether the shares or subordinated notes and debentures have been held for a period of not more than six months.
- i. *Regulation U (12 CFR 221).* While reviewing credit files, check the following for all loans that are secured directly or indirectly by margin stock and that were extended for the purpose of buying or carrying margin stock:
- Except for credits specifically exempted under Regulation U, determine that the required Form FR U-1 has been executed for each credit by the customer and that it has been signed and accepted by a duly authorized officer of the bank acting in good faith.
  - Determine that the bank has not extended more than the maximum loan value of the collateral securing such credits, as set by section 221.7 of Regulation U, and that the margin requirements are being maintained.
  - Determine compliance with other specific exceptions and restrictions of the regulation as they relate to the credits reviewed.
- j. *Regulation K (12 CFR 211) and Regulation Y (12 CFR 225), International Banking Operations.*
- Review all applicable sections, especially those concerned with—
    - loans or extensions of credit to foreign banks,
    - loans to executive officers of foreign branches of state member banks,
    - a statement of policy or the availability of information to facilitate supervision of foreign operations, and
    - reporting and disclosure of international assets and accounting for fees on international loans.
- k. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions, Retention of Credit Files.* Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over \$10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (See 31 CFR 1010.410.) (Loans secured by an interest in real property are exempt.)
- l. *Export-Import Bank of the United States.* Review extensions of credit to determine compliance with Eximbank's lending standards, policies, guidelines, and regulations as they relate to direct lending programs, cooperative financing facilities, private export funding, exporter credit programs, medium-term export debt obligations, leasing, loan guarantees, export credit insurance, and discount programs.
- m. *7 CFR 1400–1499, Commodity Credit Corporation.* Determine the compliance of international loans relating to Commodity Credit Corporation programs.
- n. *22 CFR 200–299, Agency for International Development.* Review to determine the compliance of international loans related to Agency for International Development programs.
- o. *Section 909, International Lending Supervision Act (12 USC 3908).* Section 909 of the International Lending Supervision Act of 1983 (the act) requires that FDIC-insured banks and Edge and agreement corporations prepare a written economic feasibility evaluation signed by a senior official of the banking institution for any proposed extension of credit by the lead U.S. banking institution or institutions, which individually or when

aggregated with credits of other U.S. banking institutions exceeds \$20 million per project, to finance the construction or operation of any mining operation, any metal or mineral primary processing operation, any metal fabricating facility or operation, or any metal-making (semi- and finished) operation located outside the United States or its territories or possessions. The act stipulates that the evaluation shall consider the profit potential, the competitive and economic impact of the project, and the reasonable expectation of repayment. The act also mandates that any new evaluations be reviewed by federal examiners in the context of every examination. The following checklist should be used to test compliance with the requirements of the act:

- Does the banking institution have a written economic feasibility evaluation for all credit extensions by that banking institution alone or in conjunction with other U.S. banking institutions, which individually or when aggregated with credits of other U.S. banking institutions exceed \$20 million per project, to finance any of the designated projects?
  - Is the evaluation signed by a senior officer of the examined or the lead U.S. banking institution?
  - Does the evaluation consider the following:
    - profit potential of the project
    - impact of the project on world markets
    - inherent competitive advantages and disadvantages of the project over the entire life of the project
    - the likely effect of the project on the overall long-term economic development of the country in which it is located
    - the reasonable expectation of repayment from revenues generated by the project, without regard to any subsidy provided by the government involved or any instrumentality of any country
- responses to the foregoing questions would be indicative of noncompliance with the statute and should be discussed with the appropriate level of bank management. Any apparent violations should be cited in the examination report, along with a discussion of any remedial actions taken by bank management during the examination.
16. Perform the appropriate steps in “Concentrations of Credit,” section 2050.3.
  17. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    - a. delinquent loans;
    - b. violations of laws and regulations;
    - c. loans not supported by current and complete financial information;
    - d. loans on which collateral documentation is deficient;
    - e. concentrations of credit;
    - f. criticized loans;
    - g. inadequately collateralized loans;
    - h. extensions of credit to major shareholders, employees, officers, directors, and their related interests;
    - i. loans whose ultimate collection is questionable for any other reason; and
    - j. other matters regarding the condition of the department.
  18. Provide details of classified international participation loans that are not covered by the Shared National Credit Program. Include the names and addresses of all participating state member banks and copies of the criticized loan comments.
  19. Provide the examiner-in-charge with your findings on—
    - a. the adequacy of written policies relating to international loans;
    - b. the manner in which bank officers are operating in conformance with established policy;
    - c. adverse trends within the international lending function;
    - d. the accuracy and completeness of the schedules obtained from “International—Loan Portfolio Management,” section 7020.3.
    - e. internal control deficiencies or exceptions;
    - f. recommended corrective action when policies, practices, or procedures are deficient;
    - g. the competency of management of the

Although the bank’s evaluation should be done in a professional manner, examiners need not verify its accuracy. However, any negative

- international lending function; and
  - h. other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

# International—Loans and Current Account Advances

## Internal Control Questionnaire

Effective date March 1984

Section 7030.4

Review the bank's internal controls, policies, practices, and procedures for granting and servicing international loans. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan policies that:
  - a. Establish procedures for reviewing international loan applications?
  - b. Define qualified borrowers?
  - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are international loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary international loan records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
- \*4. Are the subsidiary international loan records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle loans and post records?
5. Are the following properly recorded as "loans" for accounting and call report purposes:
  - a. Acceptances of other banks purchased?
  - b. Own acceptances purchased (discounted)?
  - c. Customer's liability to the bank on drafts paid under letters of credit for which the bank has not been reimbursed?

- \*6. Is a loan delinquency report prepared for and reviewed by management frequently (if so, how often \_\_\_\_\_)?
- \*7. Are inquiries about loan balances received and investigated by persons who do not process loans, handle settlements, or post records?
- \*8. Are bookkeeping adjustments checked and approved by an appropriate officer?
  9. Is a daily record maintained summarizing loan transaction details, i.e., loans granted, payments received, and interest collected, to support applicable general ledger account entries?
10. Are frequent note (or record copy) and liability trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

### INTEREST

- \*11. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
12. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

### COLLATERAL

13. Are multicopy, pre-numbered records maintained that detail the complete description of collateral pledged?
14. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
15. Is negotiable collateral held under joint custody?
16. Are receipts obtained and filed for released collateral?
17. Are securities valued and margin requirements reviewed at least monthly?

18. When collateral support is the cash surrender value of insurance policies, is a periodic accounting received from the insurance company and maintained with the policy?
19. Is a record maintained of entry to the collateral vault?
20. Are stock powers filed separately to bar negotiability and to deter abstraction of both the security and the negotiating instrument?
21. Are securities out for transfer, exchange, etc., controlled by pre-numbered temporary vault-out tickets?
22. Are pledged deposit accounts properly coded to negate unauthorized withdrawal of funds?
23. Are acknowledgements received for pledged deposits held at other banks?
24. Is an officer's approval necessary before collateral can be released or substituted?
  - a. Is collateral appraised by an officer general when the loan is made and at frequent intervals thereafter?
  - c. Determines that items released on temporary vault-out tickets are authorized and have not been outstanding for an unreasonable length of time?
  - d. Determines that loan payments are promptly posted?
28. Are all notes and advances recorded on a register or similar record and assigned consecutive numbers?
29. Are payment notices prepared and sent by someone not connected with loan processing?
30. Are any notes signed by a customer in blank and held in anticipation of future borrowings properly safeguarded?
31. Are lending officers frequently informed of maturing loans and credit lines?

## OTHER

25. Are notes and advance slips safeguarded during bank hours and locked in the vault overnight?
26. Are all loan rebates approved by an officer and made only by official check?
27. Does the bank have an internal review system that:
  - a. Re-examines collateral items and supporting documentation for negotiability and proper assignment?
  - b. Test checks values assigned to collat-

## CONCLUSION

32. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
33. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

When banks engage in international lending, they undertake customary credit risk as denoted by the possibility of nonpayment because of an obligor's weak financial condition or a lack of adequate collateral protection. International lending also bears risks associated with conditions within a foreign borrower's home country; these risks are commonly referred to as country risk. Conditions that may give rise to country risk include a country's underlying economic, political, and social trends and movements that may have potential consequences for foreigners' debt and equity investments in that country. In addition to the adverse effect that deteriorating economic conditions and political and social unrest may have on the rate of default by obligors in a country, country risk includes the possibility of nationalization or expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation. An assessment about the level of country risk should reflect an evaluation of the effect of prevailing (and possible future) economic, political, and social conditions on a country's ability to sustain external debt service, as well as reflect the impact of these conditions on the credit risk of individual counterparties located in the country.

Transfer risk is a facet of country risk. It is the possibility that an asset cannot be serviced in the currency of the payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability.<sup>1</sup>

The traditional examination approach to commercial credit risk is treated separately in other sections of this manual. The purpose of this section is to delineate the current examination policies, objectives, and procedures for evaluating a bank's country- and transfer-risk exposures and its management system for monitoring and controlling them.

## COUNTRY RISK

Country or sovereign risk encompasses the entire

1. Exchange controls are an example of transfer risk. The Interagency Country Exposure Review Committee (ICERC) assigns ratings to foreign exposures based on its evaluation of the level of transfer risk associated with a country. See the *Guide to the Interagency Country Exposure Review Committee Process*, which was issued in November 2008, for a comprehensive discussion of the operations of the ICERC. See also section 7040.3.

spectrum of risks and factors that arise from the economic, social, and political environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. A detailed description of these factors is described below.

### Macroeconomic Factors

The first factor affecting country risk is the size and structure of a country's external debt in relation to its economy, more specifically—

- the current level of short-term debt and the potential effect that a liquidity crisis would have on the ability of otherwise creditworthy borrowers in the country to continue servicing their obligations, and
- to the extent the external debt is owed by the public sector, the ability of the government to generate sufficient revenues, from taxes and other sources, to service its obligations.

The condition and vulnerability of the country's current account is also an important consideration, including—

- the level of international reserves, including forward market positions of the country's monetary authority (especially when the exchange rate is fixed);
- the level of import coverage provided by the country's international reserves;
- the importance of commodity exports as a source of revenue, the existence of any price-stabilization mechanisms, and the country's vulnerability to a downturn in either its export markets or the price of an exported commodity; and
- the potential for sharp movements in exchange rates and their effect on the relative price of the country's imports and exports.

The role of foreign sources of capital in meeting the country's financing needs is another important consideration in the analysis of country risk, including—

- the country's access to international financial markets and the potential effects of a loss of market liquidity;

- the country's relationships with private-sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country;
- the country's current standing with multilateral and official creditors, including the ability of the country to qualify for and sustain an International Monetary Fund or other suitable economic adjustment program;
- the trend in foreign investments and the country's ability to attract foreign investment in the future; and
- the opportunities for privatization of government-owned entities.

Past experience has highlighted the importance of a number of other important macroeconomic considerations, including—

- the degree to which the country's economy may be adversely affected through the contagion of problems in other countries;
- the size and condition of the country's banking system, including the adequacy of the country's system for bank supervision and any potential burden of contingent liabilities that a weak banking system might place on the government;
- the extent to which state-directed lending or other government intervention may have adversely affected the soundness of the country's banking system, or the structure and competitiveness of the favored industries or companies; and
- for both in-country and cross-border exposures, the degree to which macroeconomic conditions and trends may have adversely affected the credit risk associated with counterparties in the country.

## Social, Political, and Legal Climate

The analysis of country risk should also consider the country's social, political, and legal climate, including—

- the country's natural- and human-resource potential;
- the willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action;
- the degree to which political or regional

- fractionalism or armed conflicts are adversely affecting the government of the country;
- any trends toward government-imposed price, interest-rate, or exchange controls;
- the degree to which the country's legal system can be relied on to fairly protect the interests of foreign creditors and investors;
- the accounting standards in the country and the reliability and transparency of financial information;
- the extent to which the country's laws and government policies protect parties in electronic transactions and promote the development of technology in a safe and sound manner;
- the extent to which government policies promote the effective management of the institution's exposures; and
- the level of adherence to international legal and business-practice standards.

## Institution-Specific Factors

Finally, an institution's analysis of country risk should consider factors relating to the nature of its actual (or approved) exposures in the country, including, for example—

- the institution's business strategy and its exposure-management plans for the country;
- the mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio;
- the economic outlook for any specifically targeted industries within the country;
- the degree to which political or economic developments in a country are likely to affect the institution's chosen lines of business in the country (For instance, the unemployment rate or changes in local bankruptcy laws may affect certain activities more than others.);
- for an institution involved in capital markets, its susceptibility to changes in value based on market movements (As the market value of claims against a foreign counterparty rises, the counterparty may become less financially sound, thus increasing the risk of nonpayment. This is especially true for over-the-counter derivative instruments.);

- the degree to which political or economic developments are likely to affect the credit risk of individual counterparties in the country (For example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country.); and
- the institution's ability to effectively manage its exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.

## Risk-Management Process for Country Risk

Country risk has an overarching effect on an institution's international activities and should explicitly be taken into account in the risk assessment of all exposures (including off-balance-sheet) to all public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest counterparties in a country will increase if, for example, political, social, or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise. Country risk can occur in many different forms, and the nature of specific risks can change over time. A U.S. banking organization with significant direct or indirect international exposure should have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. Examiners should be continually evaluating the adequacy of the country-risk management process at internationally active institutions, and they should regularly update their assessments. An institution's country-risk management process should give particular attention to any concentrations of country risk.

Country risk is not necessarily limited to institutions with direct international exposures. Domestic counterparties with significant economic dependence on a foreign country or region (for example, through export dependence) can pose an indirect country risk to institutions that do not have direct international activity. While institutions are not required to incorporate indirect country risk into a formal

country-risk management process, they should nevertheless take these country-risk factors into account, where appropriate, when assessing the creditworthiness of domestic counterparties. Examiners should ensure that the overall credit-risk management process takes into account indirect country risk where applicable in all supervised institutions.

To effectively control the risk associated with international activities, institutions must have a risk-management process that focuses on the broadly defined concept of country risk. A sound country-risk management process includes effective oversight by the board of directors, adequate risk-management policies and procedures, an accurate country-exposure reporting system, an effective country-risk analysis process, a country-risk rating system, country-exposure limits, ongoing monitoring of country conditions, periodic stress testing of foreign exposures, and adequate internal controls and an audit function.

### *Oversight by the Board of Directors*

If country risk is to be managed properly, the board of directors must oversee the process effectively. The board is responsible for periodically reviewing and approving policies governing the institution's international activities to ensure that they are consistent with the institution's strategic plans and goals. The board is also responsible for reviewing and approving limits on country exposure and ensuring that management is effectively controlling the risk. When evaluating the adequacy of the institution's capital and allowance for loan and lease losses (ALLL), the board should take into account the volume of foreign exposures and the ratings of the countries to which the institution is exposed.

### *Policies and Procedures for Managing Country Risk*

Bank management is responsible for implementing sound, well-defined policies and procedures for managing country risk that—

- establish risk-tolerance limits;
- delineate clear lines of responsibility and accountability for country-risk management decisions;

- specify authorized activities, investments, and instruments; and
- identify both desirable and undesirable types of business.

Management should also ensure that country-risk management policies, standards, and practices are clearly communicated to the affected offices and staff.

### *Country-Exposure Reporting System*

To effectively manage country risk, the institution must have a reliable system for capturing and categorizing the volume and nature of foreign exposures. The reporting system should cover all aspects of the institution's operations. An accurate country-exposure reporting system is also necessary to support the regulatory reporting of foreign exposures on the quarterly Country Exposure Report, FFIEC 009.

The board of directors should regularly receive reports on the level of foreign exposures. If the level of foreign exposures in an institution is significant,<sup>2</sup> or if a country to which the institution is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when a deterioration in foreign exposures would threaten the soundness of the institution.

### *Country-Risk Analysis Process*

Although the nature of the country-risk analysis process and the level of resources devoted to it will vary from institution to institution, depending on the size and sophistication of its international operations, a number of considerations are relevant to evaluating the process in all institutions:

- Is there a quantitative and qualitative assessment of the risk associated with each country in which the institution is conducting or planning to conduct business?
- Is a formal analysis of country risk conducted

at least annually, and does the institution have an effective system for monitoring developments in the interim?

- Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the institution may have targeted in its business strategy?
- Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the institution's exposures in a country?
- Given the size and sophistication of the institution's international activities, are the resources devoted to the analysis of country risk adequate?
- As a final check of the process, are the institution's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?

### *Country-Risk Ratings*

Country-risk ratings summarize the conclusions of the country-risk analysis process. The ratings are an important component of country-risk management because they provide a framework for establishing country-exposure limits that reflect the institution's tolerance for risk.

Because some counterparties may be more exposed to local country conditions than others, it is a common and acceptable practice for institutions to distinguish between different types of exposures when assigning their country-risk ratings. For example, trade-related and banking-sector exposures typically receive better risk ratings than other categories of exposure because the importance of these types of transactions to a country's economy has usually moved governments to give them preferential treatment for repayment.

The risk-rating systems of some institutions differentiate between public-sector and private-sector exposures. In some institutions, a country's private-sector credits cannot be rated less severely than its public-sector credits (that is, the institution imposes a "sovereign ceiling" on the rating for all exposures in a country). Both are acceptable practices.

An institution's country-risk ratings may dif-

<sup>2</sup> For purposes of this guidance, concentrations of exposures to individual countries that exceed 25 percent of the institution's tier 1 capital plus the ALLL are considered significant. However, in the case of particularly troubled countries, lesser degrees of exposure may also be considered to be significant.

fer from the ICERC-assigned transfer-risk ratings because the two ratings differ in purpose and scope. An institution's internally assigned ratings help it to decide whether to extend additional credit, as well as how it should manage existing exposures. Such ratings should, therefore, have a forward-looking and broad country-risk focus. The ICERC's more narrowly focused transfer-risk ratings are primarily a supervisory tool and should not replace a bank's own country-risk analysis process.

The ICERC only rates countries that are in default where U.S. banks' aggregate exposures meet certain thresholds. Default occurs when a country is not complying with its external debt-service obligations or is unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest fully and on time, arrearages, forced restructuring, or rollovers. The ICERC reviews countries to which the aggregate exposure of U.S. banking organizations is at least \$1 billion for at least two consecutive quarters or between \$200 million and \$1 billion if the exposure at five or more U.S. banks exceeds 25 percent of capital (tier 1 capital + ALLL).

For purposes of determining whether a country meets the threshold for review by the ICERC, aggregate exposure is based on the exposure reported in the most recent Country Exposure Lending Survey, which is published quarterly by the Federal Financial Institutions Examination Council (FFIEC). The Country Exposure Lending Survey summarizes the aggregate, by country, exposures of U.S. banks, bank holding companies, and Edge and agreement corporations filing the FFIEC 009 regulatory reporting form (Country Exposure Report). Specifically, aggregate exposure is the sum of "Transfer Risk Claims" and "Unused Commitments" and "Guarantees and Credit Derivatives."<sup>3</sup>

If a country in default does not meet at least one of the exposure criteria for two consecutive quarters, the committee decides whether it should continue to be reviewed based on the number of banks with exposure and the trend of conditions in the country.

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3. The "Guarantees and Credit Derivatives" component captures the notional value of credit derivatives sold. This measure is a conservative estimate of contingent liabilities where a bank has taken exposure to a referenced credit in the given country. Netting does not take place in the reporting of credit derivatives since counterparty positions may not offset.

### *Country-Exposure Limits*

As part of their country-risk management process, internationally active institutions should adopt a system of country-exposure limits. Because the limit-setting process often involves divergent interests within the institution (such as the country managers, the institution's overall country-risk manager, and the country-risk committee), country-risk limits will usually reflect a balancing of several considerations, including—

- the overall strategy guiding the institution's international activities,
- the country's risk rating and the institution's appetite for risk,
- perceived business opportunities in the country, and
- the desire to support the international business needs of domestic customers.

Country-exposure limits should be approved by the board of directors, or a committee thereof, and communicated to all affected departments and staff. Exposure limits should be reviewed and approved at least annually—and more frequently when concerns about a particular country arise.

An institution should consider whether its international operations are such that it should supplement its aggregate exposure limits with more discrete controls. Such controls might take the form of limits on the different lines of business in the country, limits by type of counterparty, or limits by type or tenor of exposure. An institution might also limit its exposure to local currencies. Institutions that have both substantial capital-market exposures and credit-related exposures typically set separate aggregate exposure limits for each because exposures to the two lines of business are usually measured differently.

Although country-by-country exposure limits are customary, institutions should also consider limiting (or at least monitoring) exposures on a broader (for example, regional) basis. A troubled country's problems often affect its neighbors, and the adverse effects may also extend to geographically distant countries with close ties through trade or investment. By monitoring and controlling exposures on a regional basis, institutions are in a better position to respond if the adverse effects of a country's problems begin to spread.

For institutions that are engaged primarily in direct lending activities, monthly monitoring of compliance with country-exposure limits is adequate. However, institutions with more volatile portfolios, including those with significant trading accounts, should monitor compliance with approved limits more frequently. Exceptions to approved country-exposure limits should be reported to an appropriate level of management or the board so that it can consider corrective measures.

### *Monitoring Country Conditions*

The institution should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the institution's level of exposure and the perceived level of risk. If the institution maintains an in-country office, reports from the local staff are an obviously valuable resource for monitoring country conditions. In addition, periodic country visits by the regional or country manager are important to properly monitor individual exposures and conditions in a country. The institution may also draw on information from rating agencies and other external sources.

Communication between senior management and the responsible country managers should be regular and ongoing. The institution should not rely solely on informal lines of communication and ad hoc decision making in times of crisis. Established procedures should be in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country.

### *Stress Testing*

Institutions should periodically stress-test their foreign exposures and report the results to the board of directors and senior management. As used here, stress testing does not necessarily refer to the use of sophisticated financial modeling tools, but rather to the need for all institutions to evaluate in some way the potential impact different scenarios may have on their country-risk profiles. The level of resources devoted to this effort should be commensurate with the significance of foreign exposures in the institution's overall operations.

### *Internal Controls and Audit*

Institutions should ensure that their country-risk management process includes adequate internal controls and that an audit mechanism ensures the integrity of the information used by senior management and the board to monitor compliance with country-risk policies and exposure limits. The system of internal controls should, for example, ensure that the responsibilities of marketing and lending personnel are properly segregated from the responsibilities of personnel who analyze country risk, rate country risk, and set country limits.

## TRANSFER RISK

Transfer risk focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt. The examination of transfer risk entails (1) the identification of selected country exposures of a bank that are considered significant relative to the bank's capital and the economic performance of the country; (2) the classifications of substandard, value-impaired, and loss; (3) a determination as to the adequacy of mandated special reserves against certain international assets classified value-impaired; (4) the analysis of those non-classified credits that warrant bank management's close attention and concentrations that warrant special comment; and (5) an in-depth assessment of the adequacy of the systems the bank employs to monitor and control this facet of international lending. Four report pages have been designed to reflect an examiner's analysis of the transfer-risk element in international lending for a particular bank, as follows.

The first page, "Selected Country Exposures," merely lists, without comments, exposures that are deemed significant in relation to a bank's capital and the economic performance of the country. Exposures, depending on the country grouping, are taken from the bank's last quarterly Country Exposure Report, FFIEC 009, and compared with the bank's capital as of the same date.

The second page, "Classifications Due to Transfer Risk," reflects credits ICERC has classified because of their transfer risk. Totals in each classification should be carried forward to the "Summary of Classified Items" page, with adjustments to eliminate those credits classified

because of commercial risk, in accordance with the instructions in section 7040.3.

In December 1983, the federal banking agencies adopted examination categories for identifying credits that have been adversely affected by transfer-risk problems. In addition, the International Lending Supervision Act of 1983 requires banks to establish and maintain a special reserve when the value of international assets has been impaired by a protracted inability of the borrowers in a country to make payments on external indebtedness or when no definite prospects exist for orderly restoration of debt service. Both issues are outlined in section 7040.3.

The third page, “Nonclassified Credits Warranting Attention II; Concentrations of Transfer Risk Warranting Special Comment,” identifies exposures, as of the examination date, in which

a combination of the amount outstanding in relation to the bank’s capital funds, the composition of the portfolio, and the economic performance of the country would warrant the bank to focus special attention on its exposure.

The fourth page, “Analysis of the Country Exposure Management System,” presents in narrative form an assessment of a bank’s system for monitoring and controlling its transfer-risk exposures. Included are comments relative to the bank’s procedures for measuring exposure, the system for establishing country lending limits, and the bank’s capability to analyze countries. Examination Conclusions and Comments in the report of examination may range from criticisms of weaknesses in the country-exposure-management system to high concentrations of risk in potentially weak or problematic countries.

# International—Country Risk and Transfer Risk

## Examination Objectives

Effective date April 2009

Section 7040.2

### COUNTRY-RISK MANAGEMENT

1. If the bank is internationally active, to determine the nature and extent of the bank's direct and indirect country-risk exposure.
2. If the bank has significant direct or indirect international exposure, to evaluate and determine whether it has in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities.
3. To review and determine if the bank's system of policies, procedures, and internal controls and if its rating system and stress testing for country-risk management are adequate and reliable.
4. To determine if the bank's board of directors oversees and regularly reviews its country-risk management process, approves limits on country exposure, provides for adequate capital that is commensurate with its direct and indirect country-risk exposures, and ensures that management is effectively controlling the risk.
5. To determine if management clearly communicates the bank's country-risk management policies, standards, and practices to the affected offices and staff.
6. To determine if the scope of the bank's audit function is adequate and if the function is sufficiently comprehensive to ensure the integrity of the information senior management and the board use to monitor the bank's country-risk management process. To ensure that the board of directors or its audit committee has provided for adequate audit coverage of country-risk management functions.
7. To recommend corrective action if a bank's country-risk management process and controls are deficient in relation to the level of country-risk exposure.
8. To determine if the bank is properly preparing the Country Exposure Report, FFIEC 009, which is required to be filed quarterly with the Federal Reserve Bank of New York.
9. To identify and report individual country exposures considered significant in relation to the bank's capital and the economic performance of the country.

### CLASSIFICATIONS DUE TO TRANSFER RISK

1. To evaluate the portfolio to identify those credits in countries considered subject to classification by the Interagency Country Exposure Review Committee (ICERC).
2. To determine if the bank has adequately provided the required allocated transfer risk reserves for those international assets included in the country exposures classified value impaired.
3. To develop information on the composition of those exposures subject to classification.
4. To prepare report pages on all transfer risks subject to classification.
5. To determine the effect of total transfer-risk classifications on the overall quality of the international loan portfolio, as well as on the total bank.

### NONCLASSIFIED CREDITS WARRANTING ATTENTION—CONCENTRATIONS OF TRANSFER RISK WARRANTING SPECIAL COMMENT

1. To identify and report any concentrations of transfer risk warranting special comment.
2. To develop information on the composition of those concentrations for the report page.

### ANALYSIS OF THE COUNTRY-RISK MANAGEMENT SYSTEM

1. To determine if the bank's policies, practices, procedures, and internal controls for the management of transfer risk are adequate.
2. To determine if bank officers are operating in conformance with established guidelines.
3. To prepare narrative commentary on the bank's country-exposure management system and on any noted deficiencies, in a concise reportable format.

# International—Country Risk and Transfer Risk Examination Procedures

Effective date April 2009

## Section 7040.3

### COUNTRY RISK

Country risk, which has an overarching effect on the realization of an institution's foreign assets, encompasses all of the uncertainties arising from the economic, social, and political conditions in a country. It includes the possibility of deteriorating economic conditions, political and social upheaval, nationalization and expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation.

#### Analysis of the Country-Risk Management System

Generally, all banks have systems for appraising, monitoring, and controlling their foreign-lending activities. These systems differ from bank to bank in terms of the measure of the outstanding exposure, the independence of transfer-risk assessments and control from marketing considerations, the capability to make country judgments on the basis of analytical factors and firsthand knowledge of the country, the centralization and formality of procedures, and the level of in-depth review. When performing and updating the bank's risk assessment, the central point of contact for the institution should include an analysis of the institution's direct and indirect country-risk exposures (including any significant country-risk concentrations) and the adequacy and reliability of its country-risk management. Given the variations, banks' country-risk management systems should consist of three important components.

One component is the provision for evaluation of economic trends, political developments, and the social fabric within countries where bank funds are at risk. These so-called country studies are derived from economic data supplied by the borrower or published by institutional lenders; sociopolitical commentaries; on-site reports from bank branches, subsidiaries, or affiliates; or bank-officer visits to the country.

The second component involves the undertaking by the board of directors and senior management to define the level of country exposure the bank is willing to assume. This undertaking normally includes the establishment of limits

on aggregate outstandings, maturities, and categories of risk exposures by country, which serve as a guide to operating management in the development and servicing of the bank's international credit portfolio.

The third component is the bank's internal-reporting system designed to monitor and control country exposure. A comprehensive reporting system is required to accurately assign risk exposures to the country of risk, ensure adherence to the directives of the board, provide for at least an annual review of portfolio composition in individual countries, and establish a clear-cut methodology for reporting exceptions to established limits.

A summary of the country-risk management system should be prepared. Set forth below are guidelines and procedures for examiners to use in evaluating the systems banks use to monitor and control country-risk elements in their international loan portfolios. In assessing the quality of the country-risk management system, examiners should, as a matter of course, spot-check the accuracy of the data submitted on the Country Exposure Report, FFIEC 009. The review should include the exposures for at least several countries. Material exceptions should be commented on. To prepare this summary, the examiner should perform the following procedures:

1. Obtain any written policies, procedures, or summaries of the bank's country-risk management system. Determine whether the bank's country-risk management system includes—
  - a. effective oversight by the board of directors,
  - b. adequate risk-management policies and procedures,
  - c. an accurate country-exposure reporting system,
  - d. an effective country-risk analysis process,
  - e. a country-risk rating system,
  - f. country-exposure limits,
  - g. ongoing monitoring of country conditions,
  - h. periodic stress testing of foreign exposures, and
  - i. adequate internal controls and an audit function. (See SR-02-5.)

2. Obtain the following from a review of the minutes and reports of the board of directors:
    - a. a copy of written policies covering transfer risk
    - b. the name and composition of the committee responsible for administration of transfer risk
  3. Review international-lending policies and determine—
    - a. if the board of directors regularly reviews and gives final approval to the limits on country exposure at least annually (or quarterly, if the foreign exposures are high risk or the concentrations are significant);
    - b. who initiates the country ratings and country limits;
    - c. how frequently and by whom country ratings and limits are reviewed and changed;
    - d. how the bank defines the ratings assigned to the various countries;
    - e. how country limits are determined;
    - f. who is responsible for monitoring compliance with country limits;
    - g. if country-risk limits consider—
      - the overall strategy guiding the institution's international activities,
      - the country's risk rating and the institution's appetite for risk,
      - perceived business opportunities in the country, and
      - the desire to support the international business needs of domestic customers;
    - h. to what extent country limits are viewed as guidelines that may be exceeded;
    - i. if the bank has different sublimits for private- and public-sector credits;
    - j. if separate limits are established for private- and public-sector credits;
    - k. if the board of directors or a committee thereof periodically reviews country ratings and limits, and evaluates the bank's performance against those standards;
    - l. to what extent comments or classifications of bank supervisors are considered in establishing, increasing, or decreasing country limits;
    - m. how the system has been changed since the last examination;
    - n. if the bank has a reliable system for capturing and categorizing the volume and nature of foreign exposures;
    - o. whether the bank has a system to monitor current conditions in each of the countries where it is significantly exposed;
    - p. if there is regular, ongoing communication between senior management and the responsible country managers;
    - q. if established procedures are in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country; and
    - r. whether the bank periodically conducts stress tests (financial modeling or measuring the impact of various scenarios on its country-risk profiles) of its foreign exposures and if the results are reported to senior management and the board of directors.
  4. Review reports furnished to the board or the appropriate committee to ensure that comprehensive and accurate information is being submitted on a timely basis.
  5. Obtain the bank's report on the general distribution and characteristics of the international loan portfolio and compare loan-category distributions for adherence to guidelines.
  6. During discussion with senior management, direct inquiries to—
    - a. gain insight into general management's international lending philosophy, and
    - b. elicit management responses for correction of deficiencies.
- When reporting on the bank's country-risk management system, the examiner should consider factors such as—
1. the quality of internal policies, practices, procedures, and controls over the international-lending functions;
  2. the scope and adequacy of the internal loan-review system as it pertains to country risk;
  3. causes of existing problems;
  4. commitments from management for correction of deficiencies;
  5. expectations for continued sound international lending or correction of existing deficiencies;
  6. the ability of management to monitor and control transfer risk;
  7. the general level of adherence to internal policies, practices, procedures, and controls; and
  8. the scope and adequacy of the bank's analysis of country conditions.

## TRANSFER RISK

Transfer risk is one facet of the more broadly defined concept of country risk. Transfer risk focuses more on the availability of foreign exchange to service a country's external debt.

The transfer-risk examination procedures emphasize diversification of exposure in relation to a bank's capital as the primary method of moderating transfer risk. Where concentrations are noted, the degree of risk inherent therein is assessed in light of the composition of the portfolio and the general economic and political factors that may affect the debt-service capacity of the individual countries.

## INTERAGENCY COUNTRY EXPOSURE REVIEW COMMITTEE

The Interagency Country Exposure Review Committee (ICERC) is responsible for providing an assessment of the degree of transfer risk that is inherent in the cross-border and cross-currency exposures of U.S. banks. The ICERC's transfer-risk ratings are primarily a supervisory tool and should not replace a bank's own country-risk analysis process. Supervisors expect institutions under their supervision to continue to monitor closely their cross-border exposure to all countries; to have robust country-risk assessment systems; to have appropriate sovereign exposure limits in place for each sovereign entity; to perform solid financial analysis on the sovereign entities to which the institutions are exposed; and, generally, to continue to apply sound risk management to all of their cross-border exposures, not just to the countries rated by ICERC. Such risk-management functions will continue to be evaluated during the course of regular supervisory examinations. While banks are advised of the results of the ICERC's evaluations, this information is sensitive, and adequate safeguards should be established to ensure that it is not accessible to unauthorized personnel. The chief executive officers of those banks filing the quarterly FFIEC 009 receive copies of the write-ups on classified countries for *only* those classifications applicable to their own bank. In no event should the complete listing of country groupings be divulged. This approach parallels that of the Shared National Credit Program.

To promote uniform and consistent application of these procedures, examiners should avoid ad hoc interpretations of the instructions and should address all questions to their respective offices. The federal banking agencies have developed a publication, *Guide to the Interagency Country Exposure Review Committee Process*, to clarify and make more transparent the role of the ICERC in the supervisory process. (See SR-08-12.)

## Application of ICERC Ratings

ICERC transfer-risk ratings are applicable in—

- every U.S.-chartered insured commercial bank in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions;
- every U.S. bank holding company, including its Edge and agreement corporations and other domestic and foreign nonbank subsidiaries; and
- the U.S. branches and agencies of foreign banks (however, the allocated transfer-risk reserve (ATRR) requirement does not apply to these entities).

ICERC ratings are generally applicable to all types of foreign assets held by an institution, with the exception of premises, other real estate owned, and goodwill. For purposes of the ICERC rating, the determination of where the transfer risk for a particular exposure lies takes into consideration the existence of any guarantees and is based on the country of residence of the ultimate obligor. (See the instructions for the FFIEC 009.)

The ICERC transfer-risk rating is the only rating applicable to sovereign exposures in a reviewed country (that is, direct or guaranteed obligations of the country's central government or government-owned entities). However, if they are carried on the institution's books as an investment, securities issued by a sovereign entity are also subject to the FFIEC's Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks. The FFIEC agreement provides for specific, and possibly more severe, classification treatment of sub-investment-quality securities. Furthermore, except as noted in the next paragraph, the ICERC transfer-risk rating is also the minimum

risk rating applicable to *all other* cross-border and cross-currency exposures of U.S. banks in a reviewed country.

Regardless of the currencies involved, to the extent that an institution's claims on local country residents are funded by liabilities to local country residents, the ICERC's transfer-risk ratings *do not* apply. For example, to the extent that it has liabilities to local residents (such as sterling deposits), claims of the London branch of a U.S. bank on a public- or private-sector obligor in the United Kingdom (whether the claims are denominated in sterling, dollars, or euros) are not subject to the ICERC transfer-risk rating.

The ICERC is not able to evaluate the credit risk associated with individual, private-sector exposures in a country. Therefore, based on an evaluation of credit-risk factors (including the effects of country risk), examiners may assign credit-risk ratings to individual, private-sector exposures that are more severe than the ICERC-assigned transfer-risk rating for the country. For any given private-sector exposure, the applicable rating is *the more severe* of either the ICERC-assigned transfer-risk rating for the country or the examiner-assigned credit-risk rating (including ratings assigned as a result of the Shared National Credit Program).

Questions sometimes arise concerning the consideration that examiners should give to informal expressions of support by the central government of a country for a particular borrower or sector of the economy (most often, banking). Unless they constitute a guarantee or other legally binding commitment, examiners should view such expressions of support as no more than a mitigating factor in their evaluation of the counterparty's credit risk. Informal expressions of support by the central government would not cause the counterparty's credit-risk rating to revert to the ICERC-assigned transfer-risk rating for the country.

## Special Categories of Exposure

Although the ICERC may have rated ordinary short- and/or long-term exposures in a country as substandard, value-impaired, or loss, several special categories of exposure in a country may receive a less severe transfer-risk rating if certain conditions are met, as described below.

- *Performing short-term bank and performing short-term trade exposures.*<sup>1</sup> Short-term bank and trade exposures, which have maturities of one year or less, are generally considered to have a lower level of transfer risk because, historically, they have received priority in the allocation of a country's foreign-exchange resources. In recognition of their historical performance, the ICERC usually assigns a more favorable rating to these types of exposures.
- *Securities held in trading accounts.* Presuming that there is an active and liquid market for the securities and that the bank has procedures in place to appropriately value them, the ICERC may, on a case-by-case basis, assign a less severe transfer-risk rating to specific securities held in the bank's trading account. In any case, because FASB Financial Accounting Standard No. 115 requires that they be marked-to-market, trading-account securities are not subject to an ATRR requirement.
- *Direct-equity investments.* The ICERC may, on a case-by-case basis, assign a less severe transfer-risk rating to specific direct-equity investments when *all* of the following conditions are met:
  - The investment has been marked-to-market or is valued using the equity-accounting method.
  - The institution has provided the ICERC with evidence that the foreign business is financially viable.
  - The institution has provided the ICERC with evidence of its ability to repatriate dividends, interest payments, and proceeds from the sale of assets on a timely basis.

## EXAMINATION REPORTING OF TRANSFER RISK

The entire examination section dealing with transfer risk should be placed in an international

1. A *performing credit* is current and has not been restructured to avoid delinquency or because of a deterioration in the financial condition of the borrower. A credit is considered "current" if it has not been reported as "past due" or "nonaccrual" for the bank call report. *Trade credit* consists of credit extensions that are directly related to imports or exports and that will be liquidated through the proceeds of international trade. These credit extensions will include pre-export financing only when there is a firm export sales order and the proceeds of the order will pay off the indebtedness.

operations section of the commercial report of examination. In addition, the discussion of transfer-risk assets should be separated from the discussion of all other loans and assets classified or specially mentioned elsewhere in the report.

## Selected Country Exposures

A list should be presented of those transfer-risk exposures considered large relative to the bank's own capital funds, after taking into account the economic, social, and political circumstances within a country. These exposures, which comprise total claims and contingencies, should be taken from the last quarterly FFIEC 009 filed by the bank under examination and compared with consolidated bank capital as of the same date. For this purpose, capital is defined as tier 1 and tier 2, and it should be footnoted as such on this page. The examiner should also note that this report of country exposure and its comparison with bank capital may differ from actual exposure as of the date of examination. The level at which exposure is listed is based on a review of the performance of each country by the ICERC.

Examiners are encouraged to review the instructions for preparing the country-exposure report for further information concerning the preparation of this page. While it is not expected that examiners review the country-exposure reports filed between examinations for accuracy, a spot-check to verify that such reports are being prepared properly should be made. Material reporting errors uncovered during the examination should be included in comments on reporting exceptions elsewhere in the report of examination. When bank management relies on the data generated for the country-exposure report, and when reporting exceptions are noted, comments should be incorporated in the analysis of the country-risk management system.

## Ratings and Classifications Due to Transfer Risk

A list of exposures subject to classification as a result of transfer-risk considerations should be prepared. The decision to classify a bank's exposure to a particular country is made by the ICERC based on criteria incorporated into the

provisions of the International Lending Supervision Act of 1983.

The ICERC's assessment of transfer risk reflects the committee's application of the following category definitions.

### *Substandard*

This category applies when a country is not complying with its external debt-service obligations, as evidenced by arrearages, forced restructuring, or rollovers; and if either of the two following conditions exists:

- The country is not in the process of adopting an IMF or other suitable economic adjustment program, or is not adequately adhering to such a program.
- The country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

### *Value-Impaired*

A country has protracted arrearages, as indicated by more than one of the following:

- The country has not fully paid its interest for six months.
- The country has not complied with IMF programs (and there is no immediate prospect for compliance).
- The country has not met rescheduling terms for more than one year.
- The country shows no definite prospects for an orderly restoration of debt service in the near future.

### *Loss*

A loan is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example would be an outright repudiation by a country of its obligations to banks, the IMF, or other lenders.

The ICERC also prepares the write-ups supporting each classification. Examiners are to provide commentary on the disaggregation of each country exposure subject to classification. Include comments relative to the bank's country lending limit and any references to any proposed increases or decreases to such limit.

The examiner's commentary is to be followed by a standardized write-up on each country for which the bank has exposures, prepared by the ICERC.

## ALLOCATED TRANSFER RISK RESERVE

The responsibility for recognizing and accounting for deterioration in the value of a bank's assets, including a deterioration due to transfer-risk problems, rests with the management of a bank and its auditors. The banking agencies also have a responsibility to ensure that banks are following reasonable and prudent policies in this regard, and that necessary adjustments are being made consistently. To ensure this, the federal banking agencies, pursuant to the International Lending Supervision Act, require U.S. banks to establish an ATRR on a consolidated basis against the risks presented in certain international assets whose value has been found by the ICERC to have been significantly impaired by protracted transfer-risk problems. The ATRR should be applied to certain international assets that have been classified for transfer-risk reasons as value-impaired. The act also requires that the ATRR be established by a charge against current income, be segregated from the bank's allowance for loan and lease losses (ALLL), be deducted from gross loans and leases, and not be included as part of bank capital.

The alternative to establishing an ATRR is the direct charge to the ALLL or a reduction in the principal amount of the asset by applying interest payments or other collections on the asset. However, if this alternative accounting treatment is used, the institution may not write up the value of the assets if the ATRR requirement is later reduced or eliminated. No ATRR provisions are required if the bank has previously written down or charged off the requisite amounts. Furthermore, no ATRR will be required on contingent liabilities. Instead, contingent liabilities to value-impaired countries will be reviewed on a case-by-case basis.

The ATRR amounts mandated will be reviewed regularly by the ICERC to determine if additional reserves are required or whether downward adjustments need to be made. Initially, special reserves would not apply to net new lending when additional loans are made in

the context of an IMF or other appropriate economic adjustment program, and when the lending generally enhances the debt-service capability of the country concerned. Whether an ATRR is subsequently required for these new loans would be determined by the ICERC on the basis of performance and the continued inapplicability of the established criteria.

To calculate the reserves, examiners must multiply the reserve percentage times the amount of the adjusted exposure subject to transfer risk and the ATRR. This calculation should be done on the face amount of each loan outstanding before deducting any previous write-downs. For purposes of this computation (as noted above), interest payments that have been applied to existing loan balances are tantamount to write-downs and are an acceptable alternative to the establishment of an ATRR. The number derived after the calculation should be netted against previous write-downs to arrive at the mandated ATRR. In accordance with SR-92-2, the resulting net exposure, after adjusting for the ATRR, is included in the total classified value-impaired, but is weighted like a substandard credit *only* in determining the asset quality of the bank and other measures of financial soundness. The resulting net exposure, after adjustment for the ATRR, is included in the total classified value-impaired and is looked on as a doubtful classification *only* in determining the asset quality of the bank and other measures of financial soundness. When a shortfall exists, management should be apprised and be expected to comply with the statute in establishing the required reserve. Remarks relative to any shortfall and management's actions should be made in the Examination Conclusions and Comments. Although the general rule is that all exposures rated value-impaired are subject to the ATRR requirement, over the years there have been a number of clarifications and refinements. (See 12 CFR 28, 211.43, and 347.)

Aggregate exposures rated "Substandard" are relevant to any assessment of possible concentrations of risk, and should be factored into the evaluation of the adequacy of the bank's capital and ALLL.

## OTHER MATTERS

### Discussion of Transfer Risk in the Examiner's Comments and Conclusions

As a general rule, classifications due to transfer risk are included in the total assets classified and discussed under a major heading, such as "Asset Quality." Transfer-risk classifications of any significance should be highlighted. When the bank has other exposures of concern that warrant not only senior management's special attention, but the attention of the bank's board of directors, comments may be generated under a separate caption entitled "Transfer Risks." The examiner should include comments relative to the classifications; the shortfall, if any, in the mandatory reserves against exposures considered value-impaired; concentrations warranting special comment; and any other noted deficiency, such as an ineffective country-risk management system.

### Sharing Information with State Banking Examiners

When an examination of a state member bank is being conducted concurrently or on a joint

basis with state authorities, Federal Reserve examiners may share with state banking examiners information on those countries to which the bank under examination has exposures subject to classification or comment.

### Country Categories

The complete listing of countries as prepared by the ICERC is highly confidential and for internal use only. In discussions with bank management, examiners should refer only to countries that will be commented on in that bank's examination report. In this context, any reference to a "categorization" of countries should be couched in neutral terms.

Examiners are to provide the examiner-in-charge with essential information that will help facilitate future examinations. In addition, all workpapers should be maintained in an orderly manner, properly labeled, and available for inspection when and if necessary.

# International—Country Risk and Transfer Risk

## Internal Control Questionnaire

Effective date April 2009

## Section 7040.4

1. Has the board of directors, consistent with its duties and responsibilities, adopted written objectives and policies for international loan portfolio management? Do these policies and objectives—
  - a. establish country-exposure limits for credits, including sublimits for transfer risk?
  - b. establish limits for distribution of credits by type and maturity?
  - c. acknowledge concentrations of credit within countries, and acknowledge the need to employ personnel with appropriate specialized knowledge and experience to supervise those concentrations?
2. Are objectives and policies for international loan portfolio management reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are significant changes in country conditions or levels of exposure promptly brought to the attention of the board of directors or its designated committee?
4. Are country limits revised in response to substantive changes in economic, political, and social conditions within particular countries?
5. Is a formal analysis of country risk prepared, and are country limits reviewed, updated, and approved by the board of directors at least annually?
  - a. Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the institution may have targeted in its business strategy?
  - b. Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the institution's exposures in a country?
  - c. Are the bank's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?
6. Before granting additional advances or commitments, are outstanding advances or commitments checked against appropriate country limits?
7. Are lending officers cognizant of specific country limitations?
8. Are procedures for exceeding country limits clearly defined?
9. Does the bank have a periodic foreign call program for countries?
10. Is there an internal-review system to determine that international risk assets outstanding and committed are within the bank's foreign-exposure limits?
11. Are country-risk factors (economic, political, and social) and other factors in a particular country considered in the bank's internal periodic review of its risk assets?
12. Does the bank have an adequate, current system for country-risk analysis? Does the system consist of a regular, periodic quantitative and qualitative assessment and review of risk for each country in which the bank conducts or plans to conduct business, and does this system include—
  - a. a review of country conditions on a regular basis (state the frequency and indicate who performs analyses)?
  - b. a continuing review of current country data obtained from internal and external sources?
  - c. an analysis of economic, political, social, and other factors affecting country risk?
13. Does the bank have a formal reporting system on country risk?
14. Does the reporting system provide complete exposure data quickly and in sufficient detail to assess particular risks?
15. Does the bank's country-risk evaluation system accurately recognize exposure from country to country, on the basis of legally binding guarantees, collateral, or reallocation by the office of responsibility?
16. Given the size and sophistication of the institution's international activities, are the resources devoted to the analysis of country risk adequate?
17. Is a regular determination made about each country's transfer risk, including whether transfer risk is increased due to the bank's heavy debt servicing or other financial

restraints, and whether the country has exchange controls and hard-currency restrictions?

18. Has the bank adequately provided the required allocated transfer risk reserves for

those international assets that are included in the country exposures classified value-impaired?

### INTRODUCTION

Financing foreign receivables, a specialized area of commercial lending in an international banking division, includes open-account financing, sales on consignment, advances against collections, discounting trade acceptances, banker's acceptances, factoring, and forfaiting. Certain foreign receivables are guaranteed or insured against cross-border risk by the Export-Import Bank of the United States, the Foreign Credit Insurance Association, and other U.S. and foreign organizations. Factoring is discussed in section 2180 of this manual, and accounts receivable financing is discussed in section 2160 (Asset-Based Lending) of this manual.

### OPEN-ACCOUNT FINANCING

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

The financing of open-account sales does have certain risks. Neither the lending bank nor the exporter have control over the shipping documents, and the buyer (importer) may take possession of the goods without the consent of the bank or exporter. In addition, if the importer does not register the goods with the proper authorities, the importer may not have access to the amount of foreign exchange necessary to pay for the imports at the time of payment. Perhaps the greatest risk in open-account financing is the lack of standard trade-financing documentation on which to base legal action against the importer in the event of default. Therefore, open-account sales are most appropriate when the buyer is a subsidiary of a related company or is well known to the seller and when the importing country has no significant economic, political, or social problems and,

consequently, is not encountering foreign-exchange difficulties.

### SALES ON CONSIGNMENT

Under a consignment arrangement, goods are consigned to the importer (consignee) abroad, and the exporter (consignor) retains title to them until they are sold to a third party. However, unless the shipment is made to an exporter's overseas branch or subsidiary, the exporter's credit risk may be considerable. As with open-account sales, there is a lack of standard trade-financing documentation on which to base legal action if the consignee defaults. The exporter should thoroughly understand the inherent credit risks, especially when goods are consigned to an agent, representative, or import house abroad.

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

To overcome the disadvantages of financing shipments on an open-account or consignment basis, exporters frequently ship goods against documentary collections. Consequently, the exporter, in the case of a time or arrival draft, or the exporter and the importer jointly, in the case of a sight draft, finance the shipment. The exporter and the importer may have unused credit lines with their banks and be in a position to borrow the needed money without tying the financing to the trade transaction. However, often the exporter's or the importer's regular bank lines are fully drawn down, so they may seek bank financing in the form of advances

against outward collections, discounting trade acceptances, banker's acceptances, factoring, or forfaiting.

## ADVANCES AGAINST FOREIGN COLLECTIONS

A manufacturer or merchant conducting a strictly domestic business often obtains a loan from a bank, finance company, factor, or forfaiter using accounts receivable as security. The same general type of financing vehicle is available to exporters to finance their foreign receivables.

A common method of financing foreign receivables is through the exporter pledging all outward collections to its bank. The exporter may then borrow from the bank up to a stated maximum percentage of the total amount of receivables pledged at any one time. When notes rather than drafts are used to finance foreign receivables, they are usually paid on demand, enabling the exporter to increase or decrease the loan depending on its needs and the current amount of collections outstanding. Preferably, all of the collections lodged with the exporter's bank should be pledged to the bank. When a particular collection is paid, it is remitted by a foreign collecting bank to the exporter's bank, which has already advanced the funds to the exporter. The exporter's bank then uses the proceeds of the collection to reduce the exporter's loan.

Some exporters have no need for a continuous financing arrangement but occasionally may wish to obtain financing on only one large foreign receivable. In these instances, the exporter's bank may be willing to advance funds to the exporter with only that one receivable as security. Again, the bank establishes a maximum percentage of the amount of the receivable that it is willing to advance. When payment for the receivable is obtained, the bank uses the proceeds to liquidate the loan, crediting any excess to the exporter. Bank financing in the form of advances against export receivables is an accepted practice in international trade and is not considered factoring.

Besides having a lien on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime importance. Other factors, however, are also significant. If the foreign importers are companies with strong

reputations and financial strength, the bank will likely advance a larger percentage on collections directed to them. The bank will also likely advance a larger percentage of funds to importers in those countries in which importers promptly pay drafts drawn on them. In other countries where payment is generally slow, perhaps because importers are financially weak or because U.S. dollar or other foreign-currency exchange is hard to obtain, the bank will advance a lower percentage on collections. The exporter's bank may be completely unwilling to finance collections directed to importers or countries with reputations for habitually slow payments.

When a bank advances against foreign receivables, it must carefully scrutinize the supporting documents. Since the bank wishes to maintain control of the merchandise, the bill of lading should be either "to the order of" the shipper and blank-endorsed or "to the order of" the bank. The bill of lading must not be consigned to the buyer (importer) since this gives the buyer control over the goods. Also, financed shipments should be covered by adequate insurance.

## DISCOUNTING TRADE ACCEPTANCES

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

When discounting a trade acceptance, the bank applies a discount to the face amount of the draft and advances the remainder to the exporter until the draft's maturity. The bank is "buying" the trade acceptance for value and is entitled to

any benefits from the primary obligor to which it is due as a holder in due course of a negotiable instrument. This is also the case whenever the bank advances against a single collection or a pool of collections. Any intermediary “collecting” bank also has a financial interest in the collection and has all the rights of a holder in due course under the Uniform Commercial Code.

## **BANKER’S ACCEPTANCES CREATED AGAINST FOREIGN COLLECTIONS**

During periods of tight money, banks may choose to finance foreign collections by using banker’s acceptances. Banker’s acceptances are discussed in section 7060, “International—Banker’s Acceptances,” so the following comments relate only to the financing of foreign collections.

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

## **FORFAITING**

Forfaiting is basically nonrecourse financing of receivables, similar to factoring. However, although a factor normally purchases a company’s short-term receivables, a forfait bank purchases notes that are long-term receivables with maximum maturities of eight years. The forfaiting bank has no recourse to the seller of the

goods, but gets the notes at a substantial discount in exchange for cash. Zurich and Vienna are the centers of forfaiting. Many large banks, including U.S. institutions, provide forfaiting through either their branches or specialized subsidiaries in these cities.

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

Forfaiting presents all of the risks associated with factoring, along with the risks associated with the long-term nature of purchased receivables. The examiner should review the bank’s forfaiting activities carefully to determine whether long-term receivables have been purchased from countries prone to periodic political or economic turmoil and the resulting fluctuations in exchange rates.

## **U.S. AND FOREIGN RECEIVABLES GUARANTEE AND INSURANCE PLANS**

To reduce credit, political, and other risks associated with foreign receivables financing, banks may avail themselves of a variety of guarantee and insurance plans, both public and private, that are available in many countries. Because of the complexity of the numerous plans available, an examiner must frequently rely on the technical knowledge of the staff in a bank’s international division who handle these transactions. Nevertheless, the examiner should know the risk coverage and claim adjustment provisions of the major plans. Often a bank’s experience with its receivables insurance and guarantee plans is indicative of its effectiveness and of whether the bank has properly met its responsibilities under the programs.

### **Export-Import Bank of the United States**

The Export-Import Bank of the United States (Eximbank) issues to commercial banks, for a

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

## Foreign Credit Insurance Association

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

FCIA coverage protects the exporter against the failure of the buyer to pay dollar obligations for commercial or political reasons; enables the exporter to offer foreign buyers competitive terms of payment; supports the exporter's prudent penetration of higher risk foreign markets; and gives the exporter greater liquidity and flexibility in administering a foreign receivables portfolio. The FCIA does not itself finance export sales. However, the exporter who insures account receivables against commercial and political risks is usually able to obtain financing from commercial banks and other lending institutions at lower rates and on more liberal terms than would otherwise be possible by assigning the proceeds of the FCIA insurance to the lenders.

Comprehensive FCIA policies protect exporters against nonpayment of receivables due to unforeseeable commercial and political occurrences. Commercial risks covered include insolvency or protracted default, which may be caused by economic deterioration in the buyer's market area, shifts in demand, unanticipated

competition, tariffs, or technical changes. Political risk coverage applies to defaults due to government action, such as currency inconvertibility, expropriation, and cancellation of import license, and to political disturbances, such as war, revolution, and insurrection.

FCIA generally offers four basic types of policies covering political and commercial risks:

- Short-term policies covering shipments normally sold on terms up to 180 days. The usual policy covers 100 percent of political risks and 90 percent of any losses from commercial risk.
- Medium-term policies insuring transactions from six months to five years. FCIA covers up to 100 percent of political risks and 90 percent of commercial risks, with the remainder retained by the exporter.
- Combined short-term/medium-term policies for sales that pass through distributors before reaching final buyers.
- Master policies that include the basic insurance features of the previous policies plus discretionary and deductible provisions. Under a master policy, usually only for short-term transactions, exporters may obtain FCIA authority to grant insured credit up to a certain amount without seeking prior approval. The deductible provision, used only for commercial risks and not political risks, requires the exporter to assume a fixed amount of the first loss on total debts.

(Source: *Washington Agencies That Help to Finance Foreign Trade*, seventh edition, Bankers Trust Company, New York.)

## Other Insurers

Numerous other private and governmental institutions, both in the United States and overseas, guarantee or insure risks assumed by commercial banks financing foreign receivables. Some examples of these institutions in other countries are the Export Credits Guarantee Department (ECGD) in the United Kingdom, COFACE in France, and HERMES in Germany.

In the United States, the Overseas Private Investment Corporation (OPIC), a corporation wholly owned by the U.S. government, offers insurance against the political risks of inconvertibility, expropriation, war, revolution, and insur-

rection and guarantees the repayment of private U.S. loans for U.S. citizens, U.S. concerns that are substantially and beneficially U.S.-owned,

and foreign concerns that are at least 95 percent owned by U.S. individuals or entities.

# International—Financing Foreign Receivables

## Examination Objectives

Effective date May 1996

Section 7050.2

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1. To determine if the policies, practices, procedures, and internal controls for the financing of foreign receivables are adequate.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to the financing of foreign receivables.
5. To determine compliance with laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

# International—Financing Foreign Receivables Examination Procedures

Effective date November 2003

## Section 7050.3

1. If selected for implementation, complete or update the international—financing foreign receivables section of the internal control questionnaire.
  2. Determine the scope of the examination on the basis of the evaluation of internal controls and the work performed by internal or external auditors.
  3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review, and determine if appropriate corrections have been made.
  4. Obtain trial balances of applicable customer liability records.
    - a. Reconcile balances to department controls and the general ledger.
    - b. Review reconciling items for reasonableness.
  5. Using an appropriate technique, select borrowers for examination.
  6. Prepare examiners' credit line cards to include—
    - a. customers' aggregate foreign receivables—financing liability and
    - b. debt instruments aggregating customers' total outstanding liability.
  7. Obtain the following information:
    - a. past-due, nonaccrual, and reduced-rate loans, advances, and acceptances
    - b. loans whose terms have been modified by a reduction in the interest rate or the principal payment or by a deferral of interest or principal
    - c. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
    - d. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
    - e. loan commitments and other contingent liabilities
    - f. loans to principal shareholders, officers, and directors and to their related interests (indicate which officers are considered executive officers)
  8. Review the information received and perform the following:
    - a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.* Perform procedures in step 7a of section 7030.3, "International—Loans and Current Account Advances: Examination Procedures."
    - b. *Miscellaneous loan-debit and credit-suspense accounts.*
      - Discuss with management any large or old items.
      - Perform additional procedures as considered appropriate.
- g. reports on the indebtedness of executive officers and principal shareholders and their related interests to correspondent banks
  - h. a list of correspondent banks
  - i. miscellaneous loan-debit and credit-suspense accounts
  - j. Interagency Country Exposure Review Committee determinations
  - k. criticized Shared National Credits (applicable international credits)
  - l. loans considered "problem loans" by management
  - m. background information on directors, executive officers, principal shareholders, and their related interests
  - n. specific guidelines in the lending policy governing the financing of foreign receivables
  - o. current lending authorities of officers and lending committee (or committees)
  - p. the current interest-rate structure
  - q. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
  - r. reports furnished to the loan and discount committee or any similar committee
  - s. relevant reports furnished to the board of directors
  - t. loans classified during the previous examination

- c. *Loan commitments and other contingent liabilities.* Analyze the commitments and contingent liabilities of the obligors together with the combined amounts of their current loan balances.
- d. *Loans criticized during the previous examination.* Determine disposition of loans so classified by transcribing the current balance and payment status, or the date the loan was repaid and the source of repayment.
- Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or as a result of a participation, sale, or swap with another lending institution.
  - If repayment was a result of a participation, sale, or swap, refer to step 7a of “International—Loans and Current Account Advances: Examination Procedures,” section 7030.3, for the appropriate examination procedures.
- e. *Shared National Credits.*
- Compare the schedule of foreign receivables financed included in the uniform review of Shared National Credits Program with the listing of credits selected for review to determine which loans in the sample are portions of Shared National Credits.
  - For each loan so identified, transcribe appropriate information from the schedule to line cards. No further examination procedures are necessary in this area.
- f. *Interagency Country Exposure Review Committee credits.* Identify any credits that were selected for review that are criticized for transfer-risk reasons by the Interagency Country Exposure Review Committee.
9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
10. Prepare credit line cards for any loan not in the sample that, on the basis of information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to international cash accounts, overdrafts, and other loan areas, and together
- decide who will review the borrowing relationship. Pass or retain completed credit line cards.
12. Prepare collateral line cards for all borrowers selected in the preceding steps.
13. Obtain credit files for all borrowers for whom examiner credit line cards were prepared, and complete credit line cards, where appropriate. To analyze foreign receivables financed, perform the following procedures:
- a. Analyze the customers’ balance sheets and profit-and-loss figures as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
  - b. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
  - c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, determine the primary sources of repayment, and evaluate their adequacy.
  - d. Determine compliance with provisions of loan agreements.
  - e. Review digests of officers’ memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual repayment program.
  - f. Obtain the following information:
    - *Open-account financing.*
      - whether the shipment is directed to third parties or branches and subsidiaries of the borrower
      - the financial strength and trustworthiness of the overseas buyer
      - the extent of foreign-exchange control and the availability of exchange for the importer to effect payment
      - the bank’s past experience in dealing with the borrower who sells on open account
    - *Sales on consignment.*
      - whether the shipment is directed to third parties or branches and subsidiaries of the obligor
      - the financial strength and trustworthiness of the foreign consignee
      - the responsibilities of the foreign sales agent, overseas representa-

- the extent of foreign-exchange control and the availability of exchange for that type of transaction in the country of destination
- whether the borrower's goods, without a definite buyer, are consigned abroad in the name of the borrower's bank or a foreign bank
- whether the goods being shipped are assigned to a responsible warehouseman
- any arrangements that have been made whereby the selling agent negotiates for the sale of the goods
- the regulations in the country of destination regarding the return of unsold consigned goods to the country of origin
- the bank's past experience in dealing with the borrower who sells on consignment
- *Advances against collections.*
  - the relationship between the amount collected in a month on the collections pledged as collateral and the borrower's credit limit
  - the tenor of sight drafts—a stated number of days after sight or a stated number of days after the date of the draft
  - instructions regarding delivery of documents against payment (D/P) or documents against acceptance (D/A)
  - whether amounts advanced against collections are within the percentage of advance limitation established
  - aging of drafts (collections)
  - ineligible drawees, including house bills
  - concentrations of drawees
  - financial strength of drawees
  - unusual situations such as disputes, nonacceptance of goods, and possession of goods without payment
  - dishonor and protest instructions
  - any special instructions
  - the extent of foreign-exchange controls and the availability of exchange for that type of transaction in the country of destination
- the bank's experience in dealing with the borrower who receives advances against collections
- *Discounted trade acceptances.*
  - the relationship between the amount collected in a month on the trade acceptances discounted and the borrower's credit limit
  - whether the bank discounted the trade acceptance with or without recourse
  - whether the borrower retains a percentage of the trade acceptance endorsed to the bank
  - aging of trade acceptances
  - ineligible drawees, including house bills
  - concentrations of drawees
  - financial strength of the drawees
  - unusual situations, such as disputes, nonacceptance of goods, and possession of goods without payment
  - dishonor and protest instructions
  - any special instructions
  - the extent of foreign-exchange controls and the availability of exchange for that type of transaction in the country of destination
  - the bank's experience in dealing with the borrower for whom its trade acceptances are discounted by the bank
- *Banker's-acceptance financing.*
  - the relationship between the amount collected from the foreign buyer in a month and the borrower's credit limit
  - whether the discounted draft drawn by the exporter (customer) on the exporter's bank has the same tenor as the draft addressed to the foreign buyer
  - the procedures for applying payment received from the foreign buyer to pay the bank's own acceptance
  - aging of time drafts drawn on the importer (drawee)
  - ineligible foreign buyers (drawees), including house bills
  - concentrations of foreign buyers (drawees)
  - financial strength of the foreign buyers (drawees)

- disputes, nonacceptance of goods, and possession of goods without payment
- dishonor and protest instructions
- any special instructions
- the extent of foreign-exchange control and the availability of exchange for that type of transaction in the country of destination
- the bank's experience in dealing with the borrower
- *Factoring.*
  - the extent the factor “guarantees” letters of credit opened by the bank in favor of overseas suppliers
  - whether the title documents on import transactions are consigned to or endorsed over to the factor
  - whether the importer who receives goods under trust receipt agrees to hold them in trust for the factor
  - whether the imported goods held under warehouse receipt are stored in an independent warehouse for the account of the factor
  - whether usance letters of credit are paid to the bank by the factor at maturity, and whether the resulting acceptances are charged to the bank customer's account for payment to the factor when due
  - whether the factor borrows from the bank or creates a banker's acceptance pending payment of accounts receivable resulting from the sale of goods imported under letters of credit
  - the financial strength of the importer for whom the bank opened the letter of credit
  - any disputes, nonacceptance of goods, and possession of goods without payment
  - the bank's experience in dealing with the factor
- *Forfeiting.*
  - agings of debtor accounts purchased
  - ineligible debtor accounts purchased, including affiliate receivables, if any
  - concentration of debtor accounts purchased
  - the adequacy of the bank's credit investigation before approving the sale (or signing of a sales contract) creating a receivable
  - the financial strength of the debtor accounts purchased
  - the capability of the exporter from whom receivables were purchased to provide any required after-sales service and to honor warranties
  - disputes and returns
  - the extent of foreign exchange restrictions, availability of exchange, and country risk involved that could jeopardize collection of receivables purchased
  - the bank's experience in dealing with both the debtors and the exporter
- *U.S. and foreign receivables guarantee and insurance plans.* Determine whether foreign receivables coverage by FCIA, Eximbank, or other insurance or guarantee programs is sufficient, adequately identifies risks, and is consistent with established limits.
- g. Analyze secondary support offered by guarantors and endorsers.
- h. Determine compliance with the bank's established international loan policy.
- 14. For loans in the sample, check the central liability file on borrowers indebted above the cutoff line or borrowers displaying credit weaknesses or suspected of having additional liability in other loan areas.
- 15. Transcribe significant liability and other information of officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
- 16. Determine compliance with laws and regulations pertaining to financing foreign receivables by performing the following steps.
  - a. *Lending limits.* Determine the bank's lending limit as prescribed by state law, and note any exceptions.
  - b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and the Board's Regulation W.* Perform procedures in step 15b of “International—Loans and Current Account Advances: Examination Procedures,” section 7030.3.
  - c. *18 USC 215, Receipt of Commission or*

*Gift for Procuring Loans.*

- While examining foreign receivables financing, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
  - Investigate any such suspected irregularities.
- d. *Federal Election Campaign Act (2 USC 441b), Political Contributions.*
- Determine the existence of any loans in connection with any political campaigns.
  - Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.
- e. *12 USC 1972 and Regulation Y (12 CFR 225.7), Tie-In Provisions and Exceptions.* Determine whether any credit extension is conditioned upon—
- obtaining or providing any additional credit, property, or service from or to the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
  - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit
- f. *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests, and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), as amended by the Garn–St Germain Depository Institutions Act of 1982, Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.* Perform the Regulation O procedures of “International—Loans and Current Account Advances: Examination Procedures,” section 7030.3.
- g. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions, Retention of Credit Files.* Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over \$10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (Loans secured by an interest in real property are exempt.) (See 31 CFR 1010.410.)
17. Perform the appropriate procedural steps in “Concentrations of Credit: Examination Procedures,” section 2050.3.
18. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
- a. delinquent loans;
  - b. loans not supported by current and complete financial information;
  - c. loans on which documentation is deficient;
  - d. loans with credit weaknesses;
  - e. inadequately collateralized loans;
  - f. criticized loans, including supporting commentaries;
  - g. concentrations of credit;
  - h. extensions of credit to major shareholders, officers, and directors and to their related interests;
  - i. violations of laws and regulations; and
  - j. other matters regarding the condition of the department.
19. Evaluate the bank for—
- a. the adequacy of written policies relating to financing foreign receivables;
  - b. the manner in which bank officers are operating in conformance with established policy;
  - c. adverse trends in those sections of the international sector of the bank concerned with financing foreign receivables;
  - d. the accuracy and completeness of the schedules obtained from “International—Loan Portfolio Management,” section 7020.3;
  - e. recommended corrective action when policies, practices, or procedures are deficient;
  - f. the competency of departmental management; and
  - g. other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

# International—Financing Foreign Receivables Internal Control Questionnaire

Effective date March 1984

Section 7050.4

Review the bank's internal controls, policies, practices, and procedures regarding foreign receivables financing. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

## POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written foreign receivables financing policies that:
    - a. Establish procedures for reviewing financing applications?
    - b. Establish standards for determining credit lines?
    - c. Establish standards for determining the percentage of advances made against acceptable collections (receivables)?
    - d. Define acceptable receivables (collections)?
    - e. Establish minimum requirements for verification of borrower's receivables (collections)?
    - f. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
  2. Are foreign receivables financing policies reviewed at least annually to determine if they are compatible with changing market conditions?
- \*5. Are inquiries regarding foreign receivables financing loan balances received and investigated by persons who do not normally process documents, handle settlements, or post records?
  - \*6. Are bookkeeping adjustments checked and approved by an appropriate officer?
  - \*7. Is a daily record maintained summarizing transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger entries?
  - \*8. Are frequent debt instrument and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

## DOCUMENTATION

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

## LOAN INTEREST

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

## ACCOUNTING RECORDS

- \*3. Is the preparation and posting of subsidiary records performed or adequately reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
- \*4. Are subsidiary records reconciled, at least monthly, with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle foreign receivables financing?

## COLLATERAL

- \*14. Does the bank record on a timely basis a first lien on assigned foreign receivables for each borrower?

15. Do loans granted on the security of the foreign receivables also have an assignment of the inventory?
16. Does the bank verify the borrower's receivables or require independent verification on a periodic basis?
17. Does the bank require the borrower to provide aged receivables schedules on a periodic basis?
18. Are underlying bills of lading covering shipments either to the order of the shipper or blank endorsed to the order of the bank rather than the foreign buyer?
19. Are the shipments being financed covered by adequate insurance?
- U.S. banks forwarded directly to the bank and not through the exporter?
30. If the exporter accepts importer (drawee) payments directly, are controls established or audits of exporter's books conducted (if so, explain briefly)?
31. Are employees handling collections periodically rotated, without advance notification, to other banking duties?
- \*32. Is the employee handling collection proceeds required to apply them to the borrower's advance on the same business day that payment is received?
33. Is the disposition of each collection noted on the register so that verification of disposition can be made?
- \*34. Has a regular policy of following procedures been established for sending tracers and inquiries on unpaid collections in the hands of correspondents?
- \*35. Should the foreign drawee refuse to honor the draft, are instructions clear as to what actions should be taken by the collecting bank?
36. In the event of non-payment of the collection, is the borrower promptly notified by the bank?
- \*37. Are collections against which advances have been made or trade acceptances discounted distinctly segregated from ordinary collection items?
- \*38. Are collections above maintained under memorandum control and is the control balanced regularly?
- \*39. Are collections against which advances have been made or trade acceptances discounted booked by persons other than employees handling those items?
- \*40. Are collections carried over to the next business day adequately secured?
41. Does the customer for whom trade acceptances were discounted know whether they were purchased with or without recourse to that customer?
- \*42. Do all parties, i.e., the seller (exporter), importer (buyer), and banks, clearly understand whether interest, discount, and collection charges are to be absorbed by the seller or paid by the importer?

### ADVANCES AGAINST COLLECTIONS AND DISCOUNTED TRADE ACCEPTANCES

20. Are permanent registers kept for foreign collections against which advances were made or trade acceptances discounted?
21. Are all collections indexed in a collection register?
22. Do these registers furnish a complete history of the origin and final disposition of each collection against which advances were made or trade acceptances discounted?
23. Are receipts issued to loan customers for all collections received from them?
24. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
- \*25. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collections?
26. Is a daily record maintained showing the various collections which have been paid and credited to the borrower's advance?
- \*27. Are proceeds of paid collections credited to the correct customer's advance?
28. Is an itemized daily summary made of all interest charged and received from the exporter or importer (drawee) indicating underlying collection numbers and amounts?
29. Are payments collected from importers (drawees) by foreign banks or branches of

### FACTORING

43. Has the bank properly surrendered the

shipping documents to the factor either through endorsement or consignment?

- \*44. Do bank advances or banker's acceptances to the factor in payment of sight or time draft coincide with the expected payment of the accounts receivable by the ultimate customer?

## FOREIGN CREDIT INSURANCE ASSOCIATION INSURANCE

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

## EXPORT-IMPORT BANK OF THE UNITED STATES

52. Does the bank, financing under Eximbank arrangements, have properly executed

Eximbank guarantees or commitments covering transactions?

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

## CONCLUSION

58. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
59. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

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

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

Most banker's acceptances are used to finance trade transactions. Accordingly, acceptances are often created in connection with a letter of credit, although they may arise in connection with collection or open-account transactions. (See section 7080, "International—Letters of Credit.") In general, acceptance credit is considered self-liquidating in that it must provide the means for its own payment at maturity. To accomplish this, the acceptance must be based on a specific trade transaction in which goods are being shipped before entering the channels of trade. There should be satisfactory evidence to indicate that the draft, when created, is based on an actual shipment or storage and that, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

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

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

The established market for banker's acceptances in the United States is regulated by the Federal Reserve System. Federal Reserve Banks are authorized to discount or purchase eligible banker's acceptances subject to qualitative and quantitative limits, thus providing a source of liquidity to the selling banks. The creation of banker's acceptances is governed by section 13 of the Federal Reserve Act, which establishes criteria that must be met for the instrument to be eligible for either discount or purchase by a Federal Reserve Bank. The rules governing whether an acceptance meets the eligibility requirements for discount or purchase are important for two major reasons. First, acceptances meeting the conditions of eligibility are more readily salable in the market than acceptances that do not satisfy these conditions and, as such, provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances, unlike those that are eligible, are subject to reserve maintenance requirements, thus raising the cost to the borrower over that of an eligible acceptance. The examiner must be familiar with the criteria used for determining eligibility for discount or purchase by a Federal Reserve Bank.

Section 207 of the Bank Export Services Act (title II of P.L. 97-290), which amended section 13 of the Federal Reserve Act (12 USC 372), limits the aggregate amount of eligible banker's acceptances that may be created by a member bank to 150 percent (or 200 percent with the permission of the Board) of its paid-up and unimpaired capital stock and surplus. In addition, a member bank is prohibited from creating eligible banker's acceptances for any one person in the aggregate in excess of 10 percent of the institution's capital. Eligible banker's acceptances growing out of domestic transactions are not to exceed 50 percent of the aggregate of all eligible acceptances authorized for a member

bank. All of the foregoing limitations are also applicable to U.S. branches and agencies of foreign banks that are subject to reserve requirements under section 7 of the International Banking Act of 1978 (12 USC 3105).

Banker's acceptances as a source of financing and investment offer significant advantages to

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

# International—Banker's Acceptances

## Examination Objectives

Effective date May 1996

## Section 7060.2

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

# International—Banker's Acceptances

## Examination Procedures

Effective date March 1984

## Section 7060.3

1. If selected for implementation, complete or update the banker's acceptance section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
  - a. Reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination.
6. Prepare credit line cards to include:
  - a. Customer's aggregate banker's acceptance liability.
  - b. Banker's acceptances aggregating the customer's total liability, listing:
    - Current balance of the acceptance.
      - Indicate any prepayments (anticipations) and portions sold under participation certificate.
    - Date the acceptance was created.
    - Tenor of the acceptance (give exact maturity date, if specified).
    - Type of acceptance.
      - Import.
      - Export.
      - Third country shipment.
      - Domestic shipment.
      - Storage.
      - To create dollar exchange.
      - Working capital and/or pre-export.
      - Refinancing of sight letters of credit.
      - Current status of the acceptance.
7. Obtain the following information, if applicable to banker's acceptances, which may necessitate inclusion of additional customers (borrowers) in the credit review:
  - a. Delinquencies.
  - b. Participations purchased and sold (including syndicate participations).
    - Acceptance participations sold.
    - Acceptance pool participations (borrowings).
  - c. Loan commitments and other contingent liabilities.
  - d. Extensions of credit to major stockholders, officers, directors and their interests.
  - e. Extensions of credit to executive officers, directors and their interests of correspondent banks.
  - f. Miscellaneous loan debit and credit suspense accounts.
  - g. Criticized shared national credits (applicable foreign credits).
  - h. Interagency Country Exposure Review Committee determinations.
  - i. Extensions of credit considered "problem loans" by management.
  - j. Information on directors, executive officers, principal shareholders and their interests.
  - k. Specific guidelines in the lending policy pertaining to banker's acceptances.
    - l. Each officer's current lending authority.
    - m. The current fee structure.
    - n. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
    - o. Reports furnished to the Loan and Discount Committee or any similar committee.
    - p. Reports furnished to the directorate.
    - q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
  - a. Participations purchased and sold:
    - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.
    - Determine that the books and records of the bank properly reflect the bank's liability.
    - Investigate any participations sold immediately prior to the date of examination to determine if any were sold to

- avoid possible criticism during the examination.
- b. Loan commitments (including acceptance commitments) and contingent liabilities.
    - Analyze the commitment or contingent liability if the borrower has been advised of the commitment together with the combined amounts of the current loan balance, if any.
  - c. Banker's acceptances created for officers and directors of other banks:
    - Investigate any circumstances which indicate preferential treatment.
  - d. Miscellaneous loan debit and credit suspense accounts:
    - Discuss with management any large or old items relating to banker's acceptances.
  - e. Shared national credits:
    - Compare the schedule of banker's acceptances included in the Uniform Review of National Credits Program to the sample selection to determine which banker's acceptances in the sample are portions of shared national credits (including applicable foreign credits).
    - For each banker's acceptance so identified, transcribe appropriate information from the schedule to line sheets and return the schedule. No further examination procedures are necessary for this area.
  - f. Cross-border lending:
    - Review credit risk without regard to cross-border considerations which will be analyzed separately. No further examination procedures are necessary in this area.
  - g. Loans criticized during the previous examination:
    - Determine disposition of banker's acceptances so criticized by transcribing:
      - current balance and payment status, or
      - date the banker's acceptance was repaid and the source of repayment.
10. Prepare a credit line card for any banker's acceptance not in the sample which, based on information derived from the above schedules, requires an in-depth review.
  11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other loan areas and, together, decide who will review the borrowing relationship. Pass or retain completed credit line cards.
  12. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the loans, perform the following procedures:
    - a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine the existence of any unfavorable trends.
    - b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
    - c. Review components of the balance sheet as shown in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure.
    - d. Review supporting information for the major balance sheet items and the techniques used in consolidation and determine the primary sources of repayment and evaluate their adequacy.
    - e. Review compliance with the provisions of acceptance agreements.
    - f. Review the digest of officer's memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    - g. Relate any collateral values to outstanding debt, including margin and cash collateral deposits.
    - h. Compare fees charged to the fee schedule(s) and determine that the terms are within established guidelines.
    - i. Compare the amount of banker's acceptances outstanding with the lending officer's authority.
    - j. Analyze secondary support afforded by guarantors.
    - k. Ascertain compliance with the bank's established banker's acceptance policy.

13. For banker's acceptances in the sample, check the central liability file on borrowers indebted above the cutoff and on borrowers displaying credit weaknesses or suspected of having additional liability in loan areas.
14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate obligors contained in the sample. Cross-reference line sheets to borrowers, where appropriate.
15. Determine compliance with laws, regulations, and eligibility requirements regarding banker's acceptance financing by performing the following steps:
  - a. Determine bank compliance with state limits or the aggregate amount of acceptances that may be created for any one customer, and acceptances created to furnish dollar exchange.
  - b. Determine compliance with stipulated aggregate liability limitations on acceptances outstanding. (See Federal Reserve Act, section 13 for single person and aggregate limitation provisions.)
  - c. Determine which acceptances are ineligible and therefore subject to loan limitations imposed by state law. In general, an eligible banker's acceptance is one which must arise out of a transaction described in section 13 of the Federal Reserve Act. For details of eligibility requirements, refer to the operating provisions of the Federal Open Market Committee and interpretations of the Board of Governors of the Federal Reserve System. Eligibility can be determined by reviewing documentary evidence detailing the nature of the transaction underlying the credit extended. This evidence may be correspondence, title documents or document transmittal letters which provide sufficient detail to judge eligibility according to established criteria. Details provided should cover:
    - Value of merchandise.
    - Description of merchandise.
    - Origin and destination of shipment.
    - Date of shipment.
    - Certification that the merchandise is not being financed elsewhere.
  - d. Ensure that all of the bank's own acceptances discounted that are not rediscounted, whether eligible or ineligible, are booked as loans and thus subject to the loan limitations imposed by state law.
- e. Determine if state law imposes loan limitations on eligible acceptances of other banks purchased.
- f. Review acceptance participation agreements to determine if the purchaser has recourse to the bank in the event of default by the account party, in which case the liability would be considered a borrowing. Such borrowings may be subject to limitations on indebtedness of member banks imposed by state law.
- g. Determine acceptances issued on behalf of an affiliate which constitute extensions of credit under section 23A of the Federal Reserve Act.
16. Perform appropriate procedural steps in the Concentration of Credits section.
17. Discuss with appropriate officer and prepare summaries in appropriate report form of:
  - a. Violations of laws and regulations.
  - b. Acceptances not supported by current and complete financial information.
  - c. Acceptances on which collateral documentation is deficient.
  - d. Concentrations of credit.
  - e. Criticized loans.
  - f. Inadequately collateralized acceptances, if applicable.
  - g. Banker's acceptances created for major shareholders, employees, officers, directors and related interests.
  - h. Banker's acceptances which, for any other reason, are questionable as to quality and ultimate collection.
18. Evaluate the bank with respect to:
  - a. The adequacy of written policies relating to banker's acceptances.
  - b. The manner in which bank officers are operating in conformance with established policy.
  - c. Adverse trends within the banker's acceptance department.
  - d. The accuracy and completeness of the schedules obtained.
  - e. Internal control deficiencies or exceptions.
  - f. Recommended corrective action when policies, practices or procedures are deficient.
  - g. The quality of departmental management.
  - h. Other matters of significance.
19. Update the workpapers with any information that will facilitate future examinations.

# International—Banker's Acceptances

## Internal Control Questionnaire

Effective date June 1985

## Section 7060.4

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

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written banker's acceptance policies that:
  - a. Establish procedures for reviewing banker's acceptance applications?
  - b. Define qualified customers?
  - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are banker's acceptance policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

3. Is the preparation and posting of subsidiary banker's acceptance records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
4. Are the subsidiary banker's acceptance records balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle acceptances and post records?
5. Are acceptance delinquencies prepared for and reviewed by management on a timely basis?
6. Are inquiries about acceptance balances received and investigated by persons who do not normally handle settlements or post records?
7. Are bookkeeping adjustments checked and approved by an appropriate officer?
8. Is a daily record maintained summarizing acceptance transactions details, i.e., bankers acceptances created, payments received and

fees collected, to support applicable general ledger account entries?

9. Are acceptances of other banks that have been purchased in the open market segregated on the bank's records from the bank's own acceptances created?
10. Are prepayments (anticipations) on outstanding banker's acceptances netted against the appropriate asset account "Customer Liability for Acceptances" (or loans and discounts, depending upon whether or not the bank has discounted its own acceptance), and do they continue to be shown as a liability "Bank's Liability on Acceptances"?
11. Are banker's acceptance record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record acceptance transactions?

### FEES

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

### COLLATERAL

See International—Loans and Current Account Advances section.

### OTHER

14. Are acceptance record copies, own acceptances discounted (purchased), and acceptances of other banks purchased safeguarded during banking hours and locked in the vault overnight?

15. Are blank (pre-signed) customer drafts properly safeguarded?
16. Are any acceptance fee rebates approved by an officer?
17. Does the bank have an internal review system that:
- Re-examines collateral and supporting documentation held for negotiability and proper assignment?
  - Test checks the values assigned to collateral at frequent intervals?
  - Determines that lending officers are periodically advised of maturing banker's acceptances or acceptance lines.
18. Does the bank's acceptance filing system provide for the identification of each acceptance, e.g., by consecutive numbering and applicable letter of credit, to provide a proper audit trail?
- ### CONCLUSION
19. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
20. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

U.S. banks and their overseas branches maintain interest-bearing time deposits, known as “due from banks—time,” with foreign banks and overseas branches of U.S. banks. These assets may also be referred to as placements, placings, interbank placements (deposits), call money, or redeposits. Due from banks—time deposits have maturities ranging from one day to several months or years. Certain examination procedures, internal control considerations, and verification procedures in the domestic due from banks section (section 2010) are relevant to international due from banks—time. However, the specialized nature of foreign deposits necessitates additional examination procedures.

Constraints are placed on the amount member banks may deposit with domestic depository institutions. A member bank may not keep on deposit with any depository institution not having access to the Federal Reserve discount window more than 10 percent of its paid-in and unimpaired capital and surplus funds. State member banks may keep on deposit with foreign banks an amount exceeding that 10 percent limitation.

Due from banks—time deposit activities became important with the growth of the Eurodollar market. The bulk of due from banks—time deposits now consists of Eurodollars with smaller amounts in other Eurocurrencies. Other Eurocurrency time deposits are placed in substantially the same manner as Eurodollar deposits, but may be subject to differing exchange control regulations depending on the location of the office making the deposit.

Eurodollar deposits are sometimes linked with foreign-exchange transactions. As a result, the Eurocurrency deposit trader will frequently work closely with the foreign-exchange trader when making the deposit decision. Foreign-exchange brokers may act as intermediaries if warranted by market conditions, local customers, the size of the bank, or other factors.

Due from banks—time deposits are treated as deposits in the Report of Condition, but contain the same credit and country risks as loans or extensions of credit. Consequently, a prudently managed bank should place deposits only with other sound and well-managed banks. The deposit traders should be provided with a list of approved banks with which funds can be deposited up to specific limits. Due from banks—time deposits differ from other types of credit extensions because they often represent deposits of relatively short maturity, which normally receive first priority on repayment in case of insolvency. Nevertheless, as credit and transfer risk exists, exposure limits are to be established by credit officers and not by foreign-exchange or deposit traders. These limits must be reviewed regularly by credit officers, particularly during periods of money market uncertainty or rapidly changing economic and political conditions. Incoming confirmations of transactions from depository institutions must be carefully verified against bank records to protect against fraud and error. Similarly, a systematic follow-up on nonreceipt of incoming confirmations should be closely monitored.

# International—Due from Banks—Time

## Examination Objectives

Effective date May 1996

## Section 7070.2

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1. To determine if the policies, practices, procedures, and internal controls for due from banks—time (interbank placements and call money) are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine that all due from banks—time accounts are reasonably stated and represent funds on deposit with other banks.
4. To determine whether the bank evaluates the credit quality of banks with which time accounts are maintained.
5. To determine the scope and adequacy of the internal and external audit function as it applies to international due from banks—time.
6. To determine compliance with laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, rulings, or regulations have been cited.

# International—Due From Banks—Time Examination Procedures

Effective date March 1984

## Section 7070.3

1. If selected for implementation, complete or update the Due from Banks—Time (placement and call money) section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records pertaining to due from banks—time by currency and maturity and:
  - a. Reconcile balance to department controls and general ledger.
  - b. Review reconciling items for reasonableness.
5. Determine those due from banks—time deposits that are unconfirmed as of examination date and:
  - Determine why incoming matching confirmations are lacking.
  - Review the extent of follow-up procedures.
6. Using an appropriate technique, select deposit customers for examination.
7. Prepare credit line cards on the customers selected for review to include the following:
  - a. Name of bank and location.
  - b. Customer's aggregate due from bank—time liability.
  - c. For each due from bank—time deposit placement comprising the customer's total exposure to the bank, record the following information:
    - Amount.
    - Currency.
    - Inception date.
    - Value date.
    - Maturity date.
    - Interest rate.
8. Determine whether selected customers are:
  - a. Affiliates of the bank or other banks.
  - b. Banks and not finance companies or commercial borrowers.
9. Obtain and review the following information, if applicable:
  - a. Matured and unpaid due from banks—time deposits.
  - b. Miscellaneous loan debit and credit suspense accounts.
  - c. Interagency Country Exposure Review Committee determinations.
  - d. Due from banks—time deposit placements that are considered problem assets by management.
  - e. Specific guidelines in bank policy relating to due from banks—time.
  - f. A current listing of due from banks—time approved customer lines.
  - g. The current interest rate structure.
  - h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
  - i. Reports furnished to the Board of Directors.
  - j. Due from banks—time deposit placements that were criticized during the previous examination.
  - k. A listing of due from banks—time deposits that were previously charged-off.
10. Transcribe or compare information from the above schedules to credit line cards where appropriate, and indicate any cancelled bank lines.
11. Prepare credit line cards for any due from bank—time not in the sample which, based on information derived from the above schedules, requires an in-depth review.
12. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain completed credit line cards.
13. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards where appropriate. To analyze due from banks—time, perform the following procedures:
  - a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine

- the existence of any favorable or adverse trends.
- b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
  - c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the customer's total financial structure.
  - d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
  - e. Compare each bank's balance sheet, profit and loss items and ratios with those of comparable banks in the same country to help identify banks which may be overextended.
  - f. Review compliance with provisions of due from banks—time deposit agreements.
  - g. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
  - h. Compare interest rate(s) charged to the interest rate schedule(s), and determine that the terms are within established guidelines.
  - i. Compare the amount of due from banks—time deposits with:
    - Lending officer's authority.
    - Depositor's limit established by the bank.
  - j. Detail the major owners of the bank and whether there is any support by the government.
  - k. Ascertain compliance with established bank policy.
14. For banks in the sample, check the customer central liability reporting system for any other indebtedness.
  15. Transcribe significant liability and other information on officers, principals and affiliates of banks contained in the sample. Cross-reference line cards to banks (borrowers), where appropriate.
  16. Determine compliance with state laws and regulations pertaining to due from banks—time.
  17. Determine the existence of any concentration of time deposits with other banks. Include due from banks—demand (nostro), time deposits and any call money in computation. For concentrations exceeding 25 percent of the bank's capital structure, forward information to examiners assigned "Concentrations of Credit" for possible inclusion in the report of examination.
  18. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    - a. Matured and unpaid due from banks—time deposits.
    - b. Violations of laws and regulations.
    - c. Due from banks—time deposits not supported by current and complete financial information.
    - d. Due from banks—time deposits on which documentation is deficient.
    - e. Concentrations.
    - f. Criticized credits (portions applicable to due from banks—time deposits).
    - g. Due from banks—time deposits which, for any other reason, are questionable as to quality and ultimate repayment.
    - h. Other matters regarding the condition of the department.
  19. Evaluate the bank with respect to:
    - a. The adequacy of written policies relating to due from banks—time.
    - b. The manner in which bank officers are operating in conformance with established policy.
    - c. Adverse trends within the due from banks—time department.
    - d. The accuracy and completeness of the schedules.
    - e. Internal control deficiencies or exceptions.
    - f. Recommended corrective action when policies, practices or procedures are found to be deficient.
    - g. The quality of departmental management.
    - h. Other matters of significance.
  20. Update the workpapers with any information that will facilitate future examinations.

# International—Due From Banks—Time

## Internal Control Questionnaire

Effective date March 1984

## Section 7070.4

Review the bank's internal controls, policies, practices and procedures regarding due from banks—time. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies for international due from banks—time that:
  - a. Establish maximum limits of the aggregate amount of due from bank—time deposits for each:
    - The bank?
    - The currency of deposit?
    - The country of deposit?
  - b. Restrict due from bank—time deposits to only those customers for whom lines have been established?
  - c. Establish definite procedures for:
    - Balancing of accounts?
    - Holdover deals?
    - Rendering of reports to management, external auditors and regulating agencies?
    - Accounting cutoff deadlines?
    - Handling of interest?

### CERTIFICATES OF DEPOSIT

2. Are bank issued certificates of deposits safeguarded as other negotiable investment instruments?
3. Are safekeeping receipts for certificates of deposits issued, but held by others, checked to the original purchase order for accuracy?

### DEALING ROOM INSTRUCTIONS

(Although dealing room and instructions functions must be separate, often foreign exchange

and due from bank—time activities relating to those functions are combined.)

4. Are dealer slips and contract/confirmation sets relating to due from banks—time numbered sequentially and checked periodically?
5. Is a positions clerk present in the dealing room to maintain dealers' memoranda records of due from bank—time deposits?
6. Is due from banks—time "instructions" (operations) organizationally and physically separate from the foreign exchange dealers?
- \*7. Do good communications appear to exist between the dealing room and instructions to assure:
  - a. An effective working relationship with operations and management to ensure adequate control and management information?
  - b. Coordination with operations regarding correct delivery/settlement instructions?
- \*8. Does operations maintain all official accounting records relating to due from banks—time?
- \*9. Does operations:
  - a. Balance official records against dealing room memoranda records as scheduled by management?
  - b. Check confirmations for errors?
  - c. Receive, review and control dealer's slips?
  - d. Handle all payments and receipts?
- \*10. Are confirmations compared to the general ledger entries for accuracy?

### CONFIRMATIONS

- \*11. Does operations monitor follow-up on non-receipt of incoming confirmations?
- \*12. Are outgoing and incoming confirmations ever handled by dealers who initiate due from bank—time transactions?
- \*13. Does the bank check that there are no confirmation deals dated:
  - a. Prior to the bank's own due from bank—time deal dates?
  - b. After the bank's own due from bank—time deal dates?

## TESTING ARRANGEMENTS

(See the Wire Transfer section.)

## SIGNATURE BOOKS

- \*14. Are customer signature books updated with regard to those with whom regular business is transacted?
- \*15. Does the bank check signatures on incoming confirmations for authenticity? (Many banks do not check signatures on incoming confirmations.)
- \*16. Does the bank check signatures for deals with non-bank customers?
- \*17. Are banks that do not sign confirmations asked to confirm such practice in writing over an authorized signature?

## ACCOUNT RECORDS

- \*18. Are subsidiary records reconciled with the general ledger accounts and reconciling items adequately investigated by persons who do not post transactions to such records?
- 19. Is a due from foreign bank—time deposit trial balance prepared on a periodic basis (if so, indicate frequency \_\_\_\_\_)?
- 20. Is a daily reconciliation made of due from

bank—time deposit controls to the general ledger?

- 21. Are reconciliations reviewed by an officer independent of the reconciliation?

## OTHER

- 22. Are individual interest computations checked or adequately tested by persons independent of those functions?
- 23. Are accrual balances for due from banks—time verified periodically by an authorized official (if so, indicate frequency \_\_\_\_\_)?
- 24. Do all internal entries require the approval of appropriate officials?

## CONCLUSION

- 25. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 26. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

### INTRODUCTION

Letters of credit are the most widely used instrument to finance foreign transactions. The two major types of letters of credit are the commercial documentary letter of credit and the standby letter of credit.

### COMMERCIAL DOCUMENTARY LETTERS OF CREDIT

This type of letter of credit is used most commonly to finance a commercial contract for the shipment of goods from seller to buyer. A commercial documentary letter of credit is a letter addressed by a bank (issuing bank) on behalf of its customer, a buyer of merchandise (account party), to a seller (beneficiary) authorizing the seller to draw drafts up to a stipulated amount under specified terms. The beneficiary will be paid when the terms of the letter of credit are met and the required documents are submitted to the paying bank.

Generally, the issuance of letters of credit is governed by article 5 of the Uniform Commercial Code (UCC). However, if the credit is issued under New York law, the credit will be governed instead by the Uniform Customs and Practice for Documentary Credits (UCP). The parties may also stipulate that the UCP rather than the UCC applies. Letters of credit may also be governed by foreign law. Generally, letters of credit are—

- signed and in writing,
- in favor of a definite beneficiary,
- for a specific amount of money, and
- in a form clearly stating how payment to the beneficiary is to be made and under what conditions.

In addition, they are issued with a definite expiration date.

Commercial letters of credit are issued in either irrevocable or revocable form. Once the beneficiary receives an irrevocable letter of credit, it cannot be canceled or amended without the beneficiary's consent. Conversely, a revocable letter of credit can be canceled or

amended by the issuing bank at any time without notice to or consent from the customer or the beneficiary.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay, provided the beneficiary complies with the letter's terms and conditions. In contrast, the revocable credit is not truly a bank credit but serves as a device that provides the buyer and seller with a means of settling payments. Since a revocable credit can be canceled or changed without notice, the beneficiary should not rely on the credit but rather on the willingness and ability of the buyer to meet the terms of the underlying contract.

The letter of credit may be sent to the beneficiary directly by the issuing bank or through the issuing bank's correspondent (advising bank) located in the same place as the beneficiary. The advising bank gives notice of the issuance of a letter of credit without assuming any obligation to honor demands for payment. Advised letters of credit will bear a notation by the advising bank that it makes "no engagement" or words to that effect. An irrevocable advised letter of credit is, therefore, an undertaking to pay by the issuing bank, but not by the advising bank.

Some beneficiaries (sellers), particularly those not familiar with the issuing bank, request the buyer to have the irrevocable credit issued in the buyer's country and "confirmed" by a bank in the seller's country. Confirmed letters of credit are evidenced by the confirming bank's notation: "We undertake that all drafts drawn . . . will be honored by us" or similar words. The beneficiary of a confirmed credit has a definite commitment to pay from a bank in his or her country and need not be concerned with the willingness or ability of the issuing bank to pay. An advising bank may add its confirmation and be designated in the letter as the paying bank.

Payment terms of a letter of credit usually vary from sight to 180 days, although other terms are sometimes used. The letter will specify on which bank drafts are to be drawn. If the draft is drawn at sight, the bank will effect payment upon presentation of the draft, provided the terms of the credit have been met. If the draft is drawn on a time basis, the bank will accept the draft (by stamping "Accepted" on the face of the draft), which then can be held by the seller or the bank until maturity. Alternatively, the accepted draft can be sold or discounted.

(See section 7060, “International—Banker’s Acceptances.”)

Certain categories of commercial letters of credit, such as back-to-back and red clause credits, contain an element of risk, and banks should exercise caution in their negotiation. Similarly, deferred-payment letters of credit, which become direct assets and liabilities of a bank after presentation and receipt of the beneficiary’s documents, involve greater potential risk when coupled with the length of time the credit is outstanding.

A transferable letter of credit enables the original beneficiary to transfer the rights of payment to one or more beneficiaries. Frequently, the beneficiary is a middleman who does not own the goods at the time the letter of credit is issued. Thus, the beneficiary may seek to use the letter of credit to finance the acquisition of the goods. Under the UCP, a transferable letter of credit may be transferred only once unless otherwise stated.

A revolving letter of credit allows for monthly shipments with payments being either cumulative or noncumulative. In the case of cumulative credits, undrawn amounts carry over to future periods. However, most letters of credit are nonrevolving and are valid for one transaction. Since the maximum exposure under an irrevocable revolving credit can be large, most revolving credits are issued in revocable form.

Documentation is of paramount importance in all letter of credit transactions. The bank is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Many letters of credit are part of continuous transactions, evolving from letters of credit to sight drafts or acceptances or to notes and advances covered by trust receipts or warehouse receipts. Ultimate repayment often depends on the eventual sale of the goods involved. Thus, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

## STANDBY LETTERS OF CREDIT

A standby letter of credit guarantees payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank’s customer). Although a standby letter of credit may arise from a commercial

transaction, it is not linked directly to the shipment of goods from seller to buyer. It may cover performance of a construction contract, serve as an assurance to a bank that the seller will honor his or her obligations under warranties, or relate to the performance of a purely monetary obligation, for example, when the credit is used to guarantee payment of commercial paper at maturity.

Under all letters of credit, the banker expects the customer to be financially able to meet his or her commitments. A banker’s payment under a commercial credit for the customer’s account is usually reimbursed immediately by the customer and does not become a loan. However, the bank makes payment on a standby letter of credit only when the customer, having defaulted on his or her primary obligation, is unable to reimburse it.

A standby letter of credit transaction involves greater potential risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit retains nothing of value to protect against loss, whereas a commercial documentary letter of credit provides the bank with title to the goods being shipped. To reduce the risk of a standby letter of credit, the issuing bank’s credit analysis of the account party should be equivalent to the analysis of a borrower in an ordinary loan situation.

The standby letter of credit transactions of state member banks are subject to the legal restrictions of Regulation H and section 23A of the Federal Reserve Act. For reporting purposes, standby letters of credit are shown as contingent liabilities in the issuer’s Report of Condition.

Under the revised capital/risk assets guidelines, banks now must allocate capital against standby letters of credit. See the capital adequacy guidelines of November 1995 for information concerning capital allocation requirements against standby letters of credit.

## ANTI-BOYCOTT REGULATIONS

The Export Administration Act of 1973 prohibits banks from taking or knowingly agreeing to take actions that support any boycott against a country friendly to the United States. Under anti-boycott regulations (which are issued by the Department of Commerce and enforced by the

Office of Anti-Boycott Compliance), U.S. banks are required to report letters of credit they receive that include illegal boycott terms or conditions and should establish an ongoing program to review all letters of credit. These regulations apply to both domestic and overseas branches of all U.S. banks.

The anti-boycott provisions prohibit banks from opening, negotiating, confirming, or paying international letters of credit that contain illegal terms or conditions. The improper language is most often seen in documentary letters of credit, sight reimbursements, and pass-on letters of credit, but may also appear in drafts and wire payments. Often, a bank's customer

may try to add improper language orally rather than in writing. Boycott language includes clauses or requirements such as—

- certification that the goods are not of a particular origin, such as Israeli or South African;
- certification that any supplier or provider of services does not appear on the Arab blacklist;
- the condition, “Do not negotiate with black-listed banks,” or words to that effect;
- a request not to ship goods on an Israeli carrier or on a vessel or carrier that calls at Israel en route to a boycotting country; and
- a request for a certificate stating the origin of the goods or the destination of the goods.

# International—Letters of Credit Examination Objectives

Effective date May 1996

## Section 7080.2

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1. To determine if objectives, policies, practices, procedures, and internal controls for letters of credit are adequate.
2. To determine whether bank officers are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations are noted.

# International—Letters of Credit Examination Procedures

Effective date March 1984

## Section 7080.3

1. If selected for implementation, complete or update the Letters of Credit section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
  - a. Reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select customers for examination.
6. Prepare examiners' credit line cards for each customer selected to include:
  - a. Total line available for letters of credit.
  - b. Total outstanding letters of credit.
    - Undrawn amount.
    - Date of issuance.
    - Expiration date of the credit.
    - Name of the beneficiary.
    - Tenor of the drafts to be drawn.
    - Purpose for the credit.
    - Issued or confirmed.
    - Revocable or irrevocable.
    - Negotiable or non-negotiable.
    - Revolving.
      - Cumulative or noncumulative.
    - Transferable.
    - Assignable.
    - Amendments.
    - Issued on behalf of domestic banks.
    - Application (with official approval) is on file and in agreement with letter of credit terms.
    - Bank's copy is initialed by the officer who signed the original letter of credit.
7. Obtain the following information if it is applicable to the letter of credit department.

Such information may necessitate inclusion of additional customers in the credit review.

  - a. Delinquencies.
  - b. Participations purchased and sold since the preceding examination (including syndicate participations).
  - c. Loan commitments and other contingent liabilities.
  - d. Letters of credit issued (or confirmed) for major shareholders, officers, directors and their related interests.
  - e. Letters of credit issued (or confirmed) for employees, officers and directors of other banks.
  - f. Miscellaneous loan debit and credit suspense accounts.
  - g. Criticized shared national credits (applicable foreign credits).
  - h. Interagency Country Exposure Review Committee determinations.
  - i. Letters of credit considered problems by management.
  - j. Information on directors, executive officers, principal shareholders and their interests.
  - k. Specific guidelines in the lending policies.
    - l. Each officer's current lending authority.
    - m. Current letter of credit commission and fee structure.
    - n. Any useful information obtained from the review of the minutes of the Loan and Discount Committee or any similar committee.
    - o. Reports furnished to the Loan and Discount Committee or any similar committee.
    - p. Reports furnished to the board of directors.
    - q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
  - a. Participations purchased and sold (including syndicate participations).
    - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.

- Determine that the books and records of the bank properly show the bank's liability.
  - Investigate any participations sold immediately prior to the date of examination to determine if any were sold to avoid possible criticism during the examination.
- b. Loan commitments and other contingent liabilities:
- Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.
- c. Letters of credit issued (or confirmed) for officers, directors and their interests:
- Investigate any circumstances which indicate preferential treatment.
- d. Letters of credit issued (or confirmed) for officers and directors of other banks:
- Investigate any circumstances which indicate preferential treatment.
- e. Miscellaneous loan debit and credit suspense accounts relating to letters or credit:
- Determine liability to the bank on drafts paid under letters of credit for work which the bank has not been reimbursed by the customer.
  - Investigate any large or old items.
- f. Shared national credits:
- Compare the schedule of letters of credit included in the program to the bank's reports of unexpired letters of credit.
  - For each letter of credit so identified, transcribe appropriate information to line cards. No further examination procedures are necessary in this area.
- g. Interagency Country Exposure Review Committee credits:
- Identify any credits that were selected for review that are criticized for transfer risk reasons by the Interagency Country Exposure Review Committee.
- h. Letters of credit criticized during the previous examination:
- Determine disposition of letters of credit so criticized by transcribing:
    - Current balance and payment status, or
    - Date the letter of credit was drawn down (refinanced), paid, expired or cancelled, and the source of repayment.
9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status relating to letters of credit.
10. Prepare credit line cards for any letter of credit not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain examination credit line cards.
12. Obtain credit files for all bank customers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the letters of credit, perform the following procedures:
- a. Analyze balance sheet and profit and loss items as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
  - b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
  - c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
  - d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
  - e. Review compliance with provisions of letter of credit agreements.
  - f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
  - g. Relate any collateral values, including margin and cash collateral deposits, to outstanding letter of credit debt.
  - h. Compare fees charged to the fee schedule(s), and determine that terms are within established guidelines.

- i. Compare the amount of letters of credit outstanding with the lending officer's authority.
- j. Analyze any secondary support afforded by guarantors.
- k. Ascertain compliance with the bank's established commercial loan policy.
- l. Analyze the following specific types of letters of credit (when applicable) to determine the following:
  - For red-clause letters of credit (packing credits)—
    - is clean advance or anticipatory drawing finance to the beneficiary (exporter or agent) authorized under the letter of credit?
    - does the beneficiary undertake to deliver, within the expiration date, the shipping documents called for in the letter of credit?
    - does the foreign bank make advances to the beneficiary, and is it paid by drawing its own draft on the opening bank, or is the beneficiary authorized to draw its draft on the issuing bank, and are the drafts received charged to the importer?
  - For traveler's letters of credit—
    - is a traveler's letter of credit authorizing the issuing bank's correspondent to negotiate drafts drawn by the beneficiary named in the credit, up to a specified amount, upon proper identification?
    - is the customer furnished with a list of the issuing bank's correspondents abroad?
    - is the letter of credit prepaid in full?
  - For back-to-back letters of credit—
    - is the backing letter of credit properly assigned as collateral to the bank issuing the letter of credit?
    - are the terms of the letter of credit issued identical to the backing credit, except that—
      - the beneficiary and account party are different,
      - the amount may be less but not more than the backing credit,
      - the expiration date is reduced by sufficient time to allow completion of the transaction before the backing letter of credit expires, and
- the beneficiary of the backing letter of credit is a regular customer of the bank opening the second letter of credit?
- For standby letters of credit—
  - do they represent undertakings to pay up to a specific amount on presentation of a draft (or drafts) or documents before a specified date?
  - do they represent obligations to a beneficiary on the part of the issuer to—
    - repay money borrowed by or advanced to, or for the account of, a party; or
    - make payment on account of any indebtedness undertaken by the account party, or make payment on account of default by the account party in the performance of an obligation, for example, default on loans, performance of contracts, or relating to maritime liens?
- For deferred-payment letters of credit (trade-related)—
  - does the letter of credit call for drawing of sight drafts with the provision that such drafts are not to be presented until a specified period after presentation and surrender of shipping documents to the bank?
  - is the bank's liability for outstanding letters of credit calling for deferred payment reflected as a contingent liability until presentation of such documents?
  - has the bank received, approved, and acknowledged receipt of the documents, thereby becoming directly liable to pay the beneficiary at a determinable future date (or dates)?
  - will payment be made to the beneficiary in a specified number of months or quarterly, semiannually, annually, or beyond? (If the bank has advanced money to the beneficiary against the deferred-payment letter of credit, with its proceeds assigned as collateral to repay the advance, the transaction should be treated as a loan rather than a

- deferred-payment letter of credit).
- For clean deferred-payment letters of credit—
    - do such deferred-payment credits call for future payment against simple receipt without documents evidencing an underlying trade transaction?
    - are such letters of credit shown as direct liabilities on the bank's records when drafts are presented by the beneficiary and received by the bank?
  - For authority to purchase—
    - is the authority to purchase with recourse to the drawer, without recourse to the drawer, or without recourse to the drawer but confirmed by the negotiating bank?
  - For Agency for International Development (AID) letters of credit—
    - does the bank have an AID letter of commitment authorizing the transaction?
    - has the bank checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the AID commitment?
    - does a letter of agreement between the bank and the foreign government exist, whereby the bank has recourse if AID fails to reimburse the bank?
  - For Commodity Credit Corporation (CCC) letters of credit—
    - does the bank have a CCC letter of commitment authorizing the bank under examination to issue letters of credit to beneficiaries supplying eligible commodities to foreign importers?
    - in instances where the bank has issued standby letters of credit in favor of the CCC, have the following requirements been met:
      - Has at least 10 percent of the financed amount been confirmed, i.e., guaranteed by a U.S. bank, for commercial credit risk? Is the total value of the credit advised through a U.S. bank?
    - For the Export-Import Bank (Eximbank) of the United States—
      - does the bank have an agency agreement from Eximbank stating—
        - that Eximbank has entered into a line of credit with a foreign borrower,
        - the amount of the line,
        - that the bank has been designated to issue the letter of credit (or credits), and
        - that any payments made under an Eximbank-approved letter of credit will be reimbursed by Eximbank?
      - has the bank checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the Eximbank agreement?
  - For advised (notified) letters of credit—
    - is the bank only advising the beneficiary without responsibility on its part? (These banks should not be examined unless the bank has notified the letter-of-credit terms erroneously to the beneficiary, thus resulting in a possible liability for the bank.)
  - For other types of letters of credit—
    - do any of the following U.S. government agencies and international organizations reimburse the bank for issuing letters of credit on their behalf:
      - International Bank for Reconstruction and Development (World Bank)
      - Inter-American Development Bank
      - Overseas Private Investment Corporation
13. For loans in the sample, check the central liability file on borrowers who are indebted above the cutoff, or on borrowers who display credit weaknesses or are suspected of having additional liability in other loan areas.
  14. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate obligors contained in the sample. Cross-reference line cards to borrowers, where appropriate.
  15. Determine compliance with section 208.24 of Regulation H regarding standby letters of

- credit by performing the following steps:
- a. Determine which letters of credit are standby letters of credit as defined by section 208.24(a) of Regulation H.
  - b. Determine that the amount of standby letters of credit does not exceed the legal limitations on loans imposed by the state (including limitations to any one customer or on aggregate extensions of credit).
    - Combine standby letters of credit with any other nonexcepted loans to the account party by the issuing bank for the purpose of applying state loan limitations to any one customer.
    - A standby letter of credit is not subject to loan limitations imposed by state law in the following instances:
      - Before or at the time of issuance of the credit, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit.
      - Before or at the time of issuance, the bank has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the bank's maximum liability under the standby letter of credit.
  - c. Determine, for standby letters of credit that constitute extensions of credit under section 23A of the Federal Reserve Act when issued on behalf of an affiliate, that—
    - the legal lending limits pertaining to loans to affiliates have not been exceeded, and
    - appropriate collateral requirements have been met.
  - d. Determine that the bank maintains adequate control and clearly earmarked subsidiary records of its standby letters of credit in conformance with section 208.24 of Regulation H.
  - e. Determine that the credit standing of the account party under any standby letter of credit is the subject of credit analysis that is equivalent to that applicable to a potential borrower in an ordinary loan situation.
16. Perform the appropriate procedural steps in the "Concentration of Credits" section.
  17. Discuss with the appropriate officer (or officers) and prepare summaries in appropriate report form of—
    - a. letters of credit not supported by current and complete financial information,
    - b. letters of credit on which collateral documentation is deficient,
    - c. inadequately collateralized letters of credit,
    - d. criticized letters of credit,
    - e. concentrations of credit,
    - f. letters of credit issued in favor of major shareholders, employees, officers, directors, and their interests,
    - g. letters of credit which, for any other reason, are questionable in quality,
    - h. violations of laws and regulations, and
    - i. other matters regarding the condition of the letters-of-credit department.
  18. Prepare and give to the examiner-in-charge a written evaluation of the letters-of-credit department with respect to—
    - a. the adequacy of written policies relating to letters of credit;
    - b. the manner in which bank officers are operating in conformance with established policies;
    - c. delinquencies relating to letters of credit, segregating those considered "A" paper;
    - d. adverse trends within the letter-of-credit department;
    - e. the accuracy and completeness of the schedules obtained;
    - f. internal-control deficiencies or exceptions;
    - g. recommended corrective action when policies, practices, or procedures are deficient;
    - h. the quality of departmental management; and
    - i. other matters of significance.
  19. Update the workpapers with any information that will facilitate future examinations.

# International—Letters of Credit Internal Control Questionnaire

Effective date March 1984

## Section 7080.4

Review the bank's internal controls, policies, practices and procedures for letters of credit issued and confirmed. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written letter of credit policies that:
  - a. Establish procedures for reviewing letter of credit applications?
  - b. Define qualified customers?
  - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are letter of credit policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary letter of credit records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
- \*4. Are the subsidiary letter of credit records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle letters of credit and post records?
- \*5. Are delinquencies arising from the non-payment of instruments relating to letters of credit prepared for and reviewed by management on a timely basis?
- \*6. Are inquiries regarding letter of credit balances received and investigated by persons who do not normally process documents, handle settlements or post records?
- \*7. Are bookkeeping adjustments checked and approved by an appropriate officer?

- \*8. Is a daily record maintained summarizing letter of credit transaction details, i.e., letters of credit issued, payments received, and commissions and fees collected, to support applicable general ledger account entries?
9. Are frequent letter of credit record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record letter of credit transactions?

### COMMISSIONS

- \*10. Is the preparation and posting of commission records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
11. Are any independent commission computations made and compared or adequately tested to initial commission records by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

### DOCUMENTATION

12. Are terms, dates, weights, description of merchandise, etc. shown on invoices, shipping documents, delivery receipts and bills of lading scrutinized for differences with those detailed in the letters of credit instruments?
13. Are procedures in effect to determine if:
  - a. The above documents are signed when required?
  - b. All copies of letters of credit are initialed by the officer who signed the original letter of credit?
  - c. All amendments to letters of credit are approved by an officer?

### COLLATERAL

(See International—Loans and Current Account Advances section.)

**DEFERRED PAYMENT LETTERS  
OF CREDIT**

- \*14. Are deferred payment letters of credit:
- Recorded as direct liabilities of the bank after it acknowledges receipt of the beneficiary's documents?
  - Included in "Other Assets" and "Other Liabilities" in the call report?

**STANDBY LETTERS OF CREDIT**

- \*15. Are standby letters of credit segregated or readily identifiable from other types of letters of credit and/or guarantees?

**OTHER**

16. Are outstanding letter of credit record copies and unissued forms safeguarded during banking hours and locked in the vault overnight?
- \*17. Are advised letters of credit recorded as memoranda accounts separate from letters of credit issued or confirmed by the bank?
18. Are letters of credit which have been issued with reliance upon a domestic bank, whether on behalf of, at the request of, or under an agency agreement with the domestic bank, recorded as contingent liabilities under the name of that domestic bank?
19. Are any commission rebates approved by an officer?

20. Does the bank have an internal review system that:
- Re-examines collateral items for negotiability and proper assignment?
  - Test check values assigned to collateral when the letter of credit is issued or confirmed and at frequent intervals thereafter?
  - Determines that customer payments of letters of credit issued are promptly posted?
  - Determines all delinquencies arising from the non-payment of instruments relating to letters of credit?
21. Are all letters of credit recorded and assigned consecutive numbers?
22. Are lending officers frequently informed of maturing letters of credit and letter of credit lines?

**CONCLUSION**

23. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
24. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

State member banks may not issue guarantees and sureties except for those that may be incidental or usual in conducting banking business, such as when a bank has a substantial interest in the performance of the transaction involved or has a segregated deposit sufficient in amount to cover its total potential liability. A state member bank also may guarantee or endorse notes or other obligations sold by the bank for its own account. The amount of the obligations covered by the guaranty or endorsement is to be recorded as a liability on the bank's records. These liabilities are included in computing the aggregate indebtedness of the bank, which may be subject to limitations imposed by state law. Furthermore, a state member bank is permitted to guarantee the deposits and liabilities of its Edge Act and agreement corporations and of its corporate instrumentalities in foreign countries.

A foreign branch of a member bank may engage in certain activities under Regulation K (12 CFR 211) in addition to its general banking powers to the extent that they are consistent with its charter. Those additional activities include guaranteeing a customer's debts or agreeing to make payment on the occurrence of readily ascertainable events, including, but not limited to, nonpayment of taxes, rentals, customs duties, the cost of transportation and loss, or the non-conformance of shipping documents. The guarantee or agreement must specify maximum

monetary liability. The liabilities outstanding are subject to loan limitations on any one customer imposed by state law.

A common example of a guarantee is a shipside bond. Frequently, in an international sale of goods, the merchandise arrives at the importer's (buyer's) port before the arrival of correct and complete bills of lading. In these instances, it is customary for the importer (buyer) to obtain immediate possession of the goods by providing the shipping company with a bank guarantee, often called a shipside bond, that holds the shipping company blameless for damage resulting from release of the goods without proper or complete documents. Usually, the bank's guarantee relies on a counter-guarantee issued to the bank by the importer.

All types of guarantees issued are to be recorded as contingent liabilities by the bank. Usually, the party for whom the guarantee was issued will reimburse the bank should it be required to pay under the guarantee; however, in certain situations, some other designated party may reimburse the bank. That other party may be designated in the guarantee agreement with the bank or in the guarantee instrument itself. The bank may also be reimbursed from segregated deposits held, from pledged collateral, or by a counter-guarantor. Letters of credit, as distinguished from guarantees, are discussed in section 7080, "International—Letters of Credit."

# International—Guarantees Issued

## Examination Objectives

Effective date May 1996

## Section 7090.2

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1. To determine if policies, practices, procedures, and internal controls for guarantees issued are adequate.
2. To determine if bank officers are operating in conformance with established guidelines.
3. To evaluate the portfolio of guarantees for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it applies to guarantees.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient and when violations of laws and regulations have been cited.

# International—Guarantees Issued Examination Procedures

Effective date March 1984

## Section 7090.3

1. If selected for implementation, complete or update the Guarantees Issued section of the Internal Control Questionnaire.
2. Determine the scope of the examination based upon the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer (account party) liability records and:
  - a. Reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select guarantee account parties for examination.
6. Prepare credit line cards to include:
  - a. Total line available for guarantees.
  - b. Total outstanding guarantees.
7. Obtain the following information if it is applicable to the guarantees issued area:
  - a. Loan commitments and contingent liabilities.
  - b. Miscellaneous loan debit and credit suspense accounts.
  - c. Criticized shared national credits.
  - d. Interagency Country Exposure Review Committee determinations.
  - e. Loans considered “problem loans” by management.
  - f. Specific guidelines in the lending policy.
  - g. Each officer’s current lending authority.
  - h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
  - i. Reports furnished to the Loan and Discount Committee or any similar committee.
  - j. Reports furnished to the board of directors.
  - k. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
  - a. Miscellaneous loan debit and credit suspense accounts:
    - Determine any liability to the bank resulting from guarantees paid by the bank for which it has not been reimbursed by an account party.
    - Discuss with management any large or old items.
    - Perform additional procedures as considered appropriate.
  - b. Shared national credits:
    - Compare the schedule of guarantees issued included in the program to the bank’s reports of unexpired guarantees.
    - For each guarantee so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these items.
  - c. Interagency Country Exposure Review Committee Credits:
    - Identify any guarantees that were selected for review that are criticized for transfer risk reason by the Interagency Country Exposure Review Committee.
9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status.
10. Prepare credit line cards for any guarantee not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, loans and current account advances, due from foreign banks—time, and other loan areas and decide who will review the borrowing relationship. Pass on or retain completed credit line cards.
12. Obtain credit files for all customers (account parties) for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the guarantees, perform the following procedures:
  - a. Analyze balance sheet and profit and loss figures as shown in current and preced-

- ing financial statements, and determine the existence of any favorable or adverse trends.
- b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
  - c. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
  - d. Review supporting information for the major balance sheet items and the techniques used in consolidation. Determine the primary sources of repayment and evaluate the adequacy of those sources.
  - e. Determine compliance with the provisions of guarantee agreements.
  - f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
  - g. Relate collateral values, if any, to outstanding guarantee.
  - h. Compare fees charged to the bank's fee schedule and determine that the terms are within established guidelines.
  - i. Compare the original amount of the guarantee with the lending officer's authority.
  - j. Analyze support afforded by counter-guarantors.
  - k. Ascertain compliance with the bank's established guarantee issued policy.
13. For guarantees issued in the sample, check central liability file on borrower(s) indebted above the cutoff or borrower(s) displaying credit weakness or suspected of having additional liability in loan areas.
  14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate account parties contained in the sample. Cross-reference line cards to borrowers, where appropriate.
  15. Determine compliance with state laws and regulations pertaining to guarantees issued by performing the following steps:
    - a. Determine that the obligations covered by such guarantees or endorsements are shown as contingent liabilities on the records and in the reports of condition of the bank and that such liabilities are included in computing the aggregate indebtedness of the bank, if such limitations are imposed by state law.
    - b. Determine which guarantees are subject to individual loan limitations to any one customer by state law. Combine guarantees with any other extensions of credit to the account party by the issuing bank subject to loan limitations imposed by state law.
  16. Perform appropriate procedural steps in the Concentration of Credits section, as applicable.
  17. Discuss with appropriate officers and prepare summaries in appropriate report form of:
    - a. Guarantees not supported by current and complete financial information.
    - b. Guarantees on which collateral documentation is deficient.
    - c. Concentrations of credit.
    - d. Criticized guarantees.
    - e. Inadequately collateralized guarantees, if applicable.
    - f. Guarantees issued in favor of major shareholders, employees, officers, directors and related interests.
    - g. Guarantees, which for any other reason, are questionable as to quality and ultimate collection.
    - h. Violations of laws and regulations.
  18. Evaluate the bank with respect to:
    - a. The adequacy of written policies relating to guarantees issued.
    - b. The manner in which bank officers are operating in conformance with established policy.
    - c. Adverse trends within the guarantees issued department.
    - d. The accuracy and completeness of the schedules obtained.
    - e. Internal control deficiencies or exceptions.
    - f. Recommended corrective action when policies, practices or procedures are deficient.
    - g. The quality of departmental management.
    - h. Other matters of significance.
  19. Update the workpapers with any information that will facilitate future examinations.

# International—Guarantees Issued

## Internal Control Questionnaire

Effective date March 1984

## Section 7090.4

Review the bank's internal controls, policies, practices and procedures for issuing and servicing guarantees. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies pertaining to guarantees issued that:
  - a. Establish procedures for reviewing guarantee applications?
  - b. Define qualified guarantee account parties?
  - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are guarantee issued policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary guarantee records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
- \*4. Are the subsidiary guarantees issued records balanced daily with the general ledger and are reconciling items adequately investigated by persons who do not normally handle guarantees?
- \*5. Are guarantee delinquencies prepared for and reviewed by management on a timely basis?
6. Are inquiries regarding guarantee balances received and investigated by persons who do not normally handle guarantees or post records?
- \*7. Are bookkeeping adjustments checked and approved by an appropriate officer?

- \*8. Is a daily record maintained summarizing guarantee transaction details, i.e., guarantees issued, guarantees cancelled or renewed, payment made under guarantees and fees collected, which support general ledger entries?
9. Are frequent guarantee instrument and liability ledger trial balances prepared and are they reconciled monthly with control accounts by persons who do not process or record guarantee transactions?

### GUARANTEE FEES

- \*10. Is the preparation and posting of fees collected records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
11. Are independent fee computations made, compared or adequately tested to initial fee records by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

### COLLATERAL

(See International—Loans and Current Account Advances section.)

### OTHER

12. Are guarantees issued instruments safeguarded during banking hours and locked in the vault overnight?
13. Are all guarantees issued recorded as liabilities and assigned consecutive numbers?
14. Are all guarantees issued recorded on individual customer (account party) liability ledgers?

### CONCLUSION

15. Is the foregoing information an adequate basis for evaluating internal control in that

there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

16. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

This section provides examiners with the basic principles and risks associated with foreign exchange trading. By its very nature, foreign exchange trading involves risk. The examiner's primary function is to understand that risk and ensure that bank management, by means of policies, limits, and systems, is controlling that risk in a prudent manner. For the purpose of this section, foreign currency money market functions will be combined with foreign exchange activities since the principles and risks are virtually the same.

In order to evaluate a bank's foreign exchange and controls, the examiner needs a basic understanding of the foreign exchange market, the commercial bank's role in the market, trading fundamentals, and the principal risks involved in trading.

The foreign exchange market exists to service the foreign currency needs of importers, exporters, manufacturers, and retailers. Foreign exchange transactions arising from international trade and investment are frequently large and recurrent.

Large or small, all foreign exchange transactions represent the exchange of one country's money for another's. The exchange rate is simply the price of one currency in terms of another.

Until the late 1970s, foreign exchange rates in this country were normally expressed and quoted in dollars per unit of foreign currency, also known as "U.S. Terms." Under this method, for example, the rate for Swiss francs would be expressed as CHF1=U.S.\$1.5500. However, because of vastly improved communications and a rapidly expanding market, it became necessary for traders worldwide to quote rates in a uniform manner. As a result, American foreign exchange traders began using foreign currency units per dollar or "European Terms" for most rates. Using European terms, the quote in this example would be U.S.\$1=CHF.64516. Thus, European terms represent the value of the U.S. dollar in units of the foreign currency. A quote in European terms is simply the reciprocal of a quote in U.S. terms. One major exception to this shift is the British pound sterling which, for historical purposes, is always quoted in U.S. terms such as 1£=\$1.7450.)

Any commercial bank which maintains due from bank balances, commonly known as "nostro" accounts, in banks in foreign countries

in the local currency has the capability of engaging in foreign exchange. The majority of U.S. banks restrict foreign exchange to the servicing of their customers' foreign currency needs. The banks will simply sell the currency at a rate slightly above the market and subsequently offset the amount and maturity of the transaction through a purchase from another correspondent bank at market rates. This level of activity involves virtually no exposure as currency positions are covered within minutes. A small profit is usually generated from the rate differential, but the activity is clearly designated as a service center.

Greater emphasis is placed on foreign exchange activity by regional banks. The servicing of the corporate customers' needs is also a priority, but most regional banks also participate in the interbank market. These banks look at the trading function as a profit center as well as a service. Such banks usually employ several experienced traders and, unlike the previous group, will take positions in given currencies based on anticipated rate movements.

Multinational banks assume, by far, the most significant role in the foreign exchange marketplace. While still servicing customer needs, these banks are heavily engaged in the interbank market and look to their foreign exchange trading operation for sizable profits. Such banks trade foreign exchange on a global basis through international branch networks.

A major aspect of any foreign exchange review is the ability of the examiner to determine if the bank has the capability to adequately handle the level of its foreign exchange volume and the extent of the exposures taken. This judgment is, by necessity, subjective; however, it must take into consideration asset size, capital base, customer volume in foreign exchange, depth and experience of traders, and management understanding of and commitment to trading. The fundamental principles of foreign exchange trading outlined below are designed to assist the examiner in this analysis.

### SPOT TRADING

Buying and selling foreign exchange at market rates for immediate delivery represents spot trading. In reality, spot trades have a "value

date” (maturity or delivery date) of two to five business days (one for Canada and Mexico). Foreign exchange rates that represent the present market value for the currency are known as spot rates. The risk of spot trading results from rate movements occurring when the bank’s position in foreign currency is not balanced with regard to exchange bought and sold. Such unbalanced positions are referred to as net open positions and are defined as follows:

*Net Open Positions*—A bank has a net position in a foreign currency when its assets, including spot and future contracts to purchase,

and its liabilities, including spot and future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net “long” position and liabilities in excess of assets a net “short” position. A “long” position in a foreign currency which is depreciating will result in an exchange loss relative to book value because, with each day, that position (asset) is convertible into fewer units of local currency. Similarly, a “short” position in a foreign currency which is appreciating represents an exchange loss relative to book value because, with each day, liquidation of that position (liability) will cost more units of

## CONSOLIDATED FOREIGN EXCHANGE POSITION, MAY 4, 20XX

Amounts in thousands

<i>Monetary Unit, Overnight Limit and Description</i>	<i>Assets/Purchases</i>		<i>Liabilities/Sales</i>	
	<i>Foreign Amount</i>	<i>U.S. \$ Equivalent of Local Currency Book Value</i>	<i>Foreign Amount</i>	<i>U.S. \$ Equivalent of Local Currency Book Value</i>
<b>JAPANESE YEN (\$3,000M)</b>				
Ledger Accounts	563,437	239,461	645,013	274,310
Spot Contracts	23,502	9,802	15,973	6,709
Forward Contracts	790,250	331,905	712,533	296,342
	<u>1,377,189</u>	<u>581,168</u>	<u>1,373,519</u>	<u>577,361</u>
Net Position (long)	3,670	3,807		
<b>CANADIAN DOLLARS (\$6,000M)</b>				
Ledger Accounts	1,016,076	1,017,525	1,029,835	1,030,057
Spot Contracts	330,021	328,972	216,225	217,246
Forward Contracts	1,202,013	1,203,226	1,301,279	1,302,522
	<u>2,548,110</u>	<u>2,549,723</u>	<u>2,547,339</u>	<u>2,549,825</u>
Net Position (long)	771			102
<b>SWISS FRANC (\$250M)</b>				
Ledger Accounts <sup>1</sup>	31,768	11,932	36,052	13,571
Spot Contracts	1,526	593	2,566	969
Forward Contracts	11,174	4,274	6,545	2,521
	<u>44,468</u>	<u>16,799</u>	<u>45,163</u>	<u>17,061</u>
Net Position (short) <sup>2</sup>			695	262

1. Does not include a Swiss franc 1,000M (U.S. \$386M) unhedged investment in a Swiss subsidiary and Swiss franc 573M (U.S. \$217M) unhedged investment in branch fixed assets. The unhedged term “long” position was approved by senior bank management.

2. Net overnight position in excess of established limit. Formally approved as a special situation by senior management prior to the transaction.

local currency. (Examples of net open position schedules appropriate for use in preparing the report of examination appear on the preceding page.)

It is important to remember that the net open position consists of both balance sheet accounts and contingent liabilities. For most banks, the nostro accounts represent the principal assets; however, foreign currency loans as well as any other assets or liability accounts denominated in foreign currency that are sizable in certain banks, must be included. All future foreign exchange contracts outstanding are contingents. When a contract matures, the entries are posted to a nostro account in the appropriate currency.

Each time a bank enters into a spot foreign exchange contract, its net open position is changed. For example, assume that Bank A opens its business day with a balanced net open position in pound sterling (assets plus purchased contracts equal liabilities plus sold contracts). This is often referred to as a “flat” position. Bank A then receives a telephone call from Bank B requesting a “market” in sterling. Because it is a participant in the interbank foreign exchange trading market, Bank A is a “market maker.” This means it will provide Bank B with a two-sided quote consisting of its bid and offer for sterling. If a different currency was requested, European terms would be the opposite as the bid and offer would be for dollars instead of the foreign currency. In determining the market given, Bank A’s trader of sterling will determine where the market presently is (from brokers and/or other banks) and attempt to anticipate where it is headed and whether Bank B is planning to buy or sell sterling.

When Bank A gives its quote on sterling, \$1.7115–25 for example, it is saying that it will buy sterling (its bid) at \$1.7115 or sell sterling at \$1.7125 (its offer). If Bank B’s interest is to buy sterling and the given quote is appealing, it will buy sterling from Bank A at \$1.7125 (Bank A’s offer of sterling). Note, that while Bank B may choose to buy, sell, or pass as it wishes, it must do business on the terms established by Bank A. These terms will be in Bank A’s favor. As soon as Bank B announces it will purchase sterling at \$1.7125, Bank A acquires a net open position (short) in sterling. Bank A must then decide whether to hold its short position (in anticipation of a decline in sterling) or cover its position. Should it wish to cover, it may call another bank and purchase the

amount it sold to Bank B. However, in this case, as the calling bank, Bank A would buy its sterling from the offered side of the quote it receives and must buy it at \$1.7125 or less to avoid a loss.

Banks engaging in interbank spot trading will often be involved with sizable net open positions, though many for just brief periods. No matter how skilled the trader, each will encounter at least occasional losses. Knowing when to close a position and take a small loss before it becomes large is a necessary trait for a competent trader. Many banks employ a “stop loss policy” whereby a net open position must be covered if losses from it reach a certain level. While a trader’s forecast may ultimately prove correct within a day or week, rapid rate movements often force a loss within an hour or even minutes. Also, access to up-to-the-minute information is vital for involvement in spot trading. Banks who lack the vast informational resources of the largest multinationals may be particularly vulnerable to sudden spot rate movements prompted by inside information or even rumors. As a result, examiners should closely review banks where foreign exchange activities consist primarily of interbank spot trading.

## FORWARD TRADING

A forward transaction differs from a spot transaction in that the value date is more than two to five business days in the future. The maturity of a forward foreign exchange contract can be a few days, months, or even years in some instances. The exchange rate is fixed at the time the transaction is agreed. But nostro accounts are not debited or credited, i.e., no money actually changes hands, until the maturity date of the contract. There will be a specific exchange rate for each forward maturity, and each of those rates will generally differ from today’s spot exchange rate. If the forward exchange rate for a currency is higher than the current spot rate, dealers say the currency is trading at a “premium” for that forward maturity. If the forward rate is below the spot rate, then the currency is said to be trading at a “discount.” For instance, sterling for value in three months is at a discount if the spot rate is \$1.75 and the three-month forward rate is \$1.72.

Banks active in the foreign exchange market find that interbank currency trading for any specific value date in the future is inefficient and

engage in it only infrequently. Instead, for future maturities, banks trade among themselves as well as with some corporate customers on the basis of a transaction known as a “swap.” A swap transaction is a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates. The key aspect is that the bank arranges the swap as a single transaction with a single counterparty, either another bank or a nonbank customer. This means that, unlike outright spot or forward transactions, a trader does not incur a net open position since the bank contracts both to pay and to receive the same amount of currency at specified rates.

A swap allows each party to use a currency for a period in exchange for another currency that is not needed during that time. Thus, the swap offers a useful investment facility for temporary idle currency balances of a corporation or a financial institution. Swaps also provide a mechanism for a bank to accommodate the outright forward transactions executed with customers or to bridge gaps in the maturity structure of its outstanding spot and forward contracts.

The two value dates in a swap transaction can be any two dates. But, in practice, markets exist only for a limited number of standard maturities. One of these standard types is called a “spot against forward” swap. In a spot against forward swap transaction, a trader buys or sells a currency for the spot value date and simultaneously sells or buys it back for a value date a week, a month, or three months later.

Another type of transaction of particular interest to professional market-making banks is called a “tomorrow-next” swap or a “rollover.” These are transactions in which the dealer buys or sells a currency for value the next business day and simultaneously sells or buys it back for value the day after. A more sophisticated type of swap is called a “forward-forward” in which the dealer buys or sells currency for one future date and sells or buys it back for another future date. Primarily, multinational banks specialize in transactions of that type.

Any swap transaction can be thought of as if it were a simultaneous borrowing and lending operation. For example, on September 11, Bank A “swaps in” three-month sterling in a spot against a forward transaction with Bank B. On September 13, Bank A pays dollars to Bank B’s account at a New York bank and Bank A receives sterling for its account at a bank in London. On December 13, the swap is reversed. Bank A pays

back the sterling to Bank B, while B pays back the dollars to A. In the meantime, Bank A has the use of the sterling, in effect “borrowing” sterling, while giving up use of the dollars, in effect “lending” the dollars. Banks recognize this close equivalence to actual short-term borrowing and lending. Many fold in swap transactions with other money market transactions in managing their global banking activities.

Forward exchange rates can be expressed in three ways. Like spot rates, outright forward prices are expressed in dollars and cents per currency unit or vice versa. Traders normally only quote forward prices to corporate customers or to small correspondent banks seeking to buy or sell a currency for a particular future date. For instance, a trader may quote an outright six-month rate to buy sterling of \$1.8450, while, by comparison, a quotation to buy spot sterling might be less (\$1.8200) or more (\$1.8625).

In swap transactions, the trader is only interested in the difference between spot and forward rates, the premium or discount, rather than the outright spot and forward rates themselves. Premiums and discounts expressed in points (\$0.0001 per pound sterling or € 0.0001 per dollar) are called swap rates. For the first spot rate above, the premium is 250 points (\$0.0250). For the second, the discount is 175 points (\$0.0175).

Since, in a swap, a trader is effectively borrowing one currency and lending the other for the period between the two value dates, the premium or discount is often evaluated in terms of percent per annum. For the examples above, the premium of 250 points is equivalent to 2.75 percent per annum, while the discount of 175 points is equivalent to 1.88 percent per annum. To calculate the percentage premium for the first case:

- Take the swap rate (\$0.0250)
- Multiply by 12 months and divide by 6 months (a per annum basis)
- Divide by the spot rate (\$1.8200), and
- Multiply by 100 (to get a percent basis).

On a formula basis, this can be expressed as:

$$\% \text{ per annum} = \left( \frac{\text{Premium or Discount} \times 12}{\text{Spot rate} \times \text{number of months of forward contract}} \right) \times 100$$

As can be seen from the above, forward rates (premiums or discounts) are solely influenced by the interest rate differentials between the two countries involved. As a result, when the differential changes, forward contracts previously booked could now be covered at either a profit or loss. For example, assume an interest rate differential between sterling and dollars of 3 percent (with the sterling rate lower). Using this formula, with a spot rate of \$1.80, the swap rate on a three month contract would be a premium of 135 points. Should that interest rate differential increase to 4 percent (by a drop in the sterling rate or an increase in the dollar rate), the premium would increase to 180 points. Therefore, a trader who bought sterling three months forward sterling at 135 points premium could now sell it at 180 points premium, or at a profit of 45 points (expressed as .0045).

Thus, the dealer responsible for forward trading must be able to analyze and project dollar interest rates as well as interest rates for the currency traded. Additionally, because forward premiums or discounts are based on interest rates differentials, they do not reflect anticipated movements in spot rates.

Active trading banks will, of course, have a large number of forward contracts outstanding. The portfolio of forward contracts is often called a "forward book." As a result, these forward positions must be managed on a gap basis. Normally, banks will segment their forward books into 15-day periods and show the net (purchased forward contracts less sold ones) balance for each period. A typical forward book would look as follows:

<i>Foreign Currency</i>	<i>Maturity Date</i>	<i>Purchases</i>	<i>Sales</i>	<i>Net Position for Period</i>
England (amounts in pound sterling)	Dec. 1–15	1 000 000	800 000	200 000
	16–31	700 000	900 000	(200 000)
	Jan. 1–15	1 500 000	500 000	1 000 000
	16–31	1 400 000	600 000	800 000
	Feb. 1–15	1 100 000	700 000	400 000
	16–28	1 400 000	400 000	1 000 000
	Mar. 1–31	200 000	1 300 000	(1 100 000)
	Apr. 1–30	400 000	1 600 000	(1 200 000)
	May 1–31	300 000	900 000	(600 000)
	June 1–30	350 000	450 000	(100 000)
	July 1–31	550 000	450 000	100 000
	Aug. 1–31	1 000 000	1 000 000	—
	Sept. 1–30	500 000	600 000	(100 000)
	Oct. 1–31	600 000	500 000	100 000
	Nov. 1–30	100 000	100 000	—
Dec. 1–31	100 000	200 000	(100 000)	
	Totals	11 200 000	11 000 000	200 000

In this forward book, volumes and net positions are limited with only the first three months segregated into 15-day periods with the remainder grouped monthly. The trader will use the forward book to manage his overall forward positions.

A forward book in an active currency may consist of numerous large contracts but, because of the risks in a net open position, total forward purchases will approximately equal total for-

ward sales. (Note: In the above forward book, the net position is only £200,000.) What matters in reviewing a forward book is the distribution of the positions by period. In the above example, the forward sterling is long a net 3,200,000 for the first three months (December through February) and short a net 3,000,000 for the next four months (March through June). In this instance, the forward book is structured for an anticipated decline in dollar interest rates as compared with

sterling interest rates since these sold positions could be offset (purchase of a forward contract to negate the sold forward position) at a lower price—either reduced premium or increased discount.

Trading forward foreign exchange thus involves projecting interest rate differentials and managing a forward book to be compatible with these projections. An understanding of these concepts is essential when looking at forward trading from risk and profitability aspects.

## COMPUTING FOREIGN EXCHANGE PROFITS AND LOSSES

If traders did nothing but spot transactions and never took open positions from day to day, calculating profit or loss would be straightforward. For example: on January 21, the traders buy £1,000,000 spot at \$1.75 and £3,000,000 at \$1.74 and sell £2,000,000 at \$1.7450 and £2,000,000 at \$1.7380. On the spot value dates, two business days later, the bank's *nostro* or clearing account in London is credited and debited by £4,000,000 from the maturing transactions.

The sterling position is square, since debits and credits are equal. In New York, the bank pays \$6,970,000 but receives only \$6,966,000. There is a net loss of \$4,000 on the four transactions. This is so because the bank's accountant would calculate that the traders acquired sterling at an average rate of \$1.7425 =

$$\frac{\$1,000,000 \times \$1.75 + \$3,000,000 \times \$1.74}{£4,000,000}$$

Against that, the traders sold sterling at \$1.7450, for a profit of \$5,000 (i.e., \$1.7450 - \$1.7425 = \$0.0025 × 2,000,000 = \$5,000). Traders also sold another £2,000,000 at \$1.7380 for a loss of \$9,000 (\$1.7380 - \$1.7425 = -\$0.0045 × £2,000,000 = -\$9,000). In this instance, the computed net loss of \$4,000 is precisely the same as the excess of dollar payments over dollar receipts.

In practice, computing profits and losses is far more complex for two basic reasons. Banks do not trade only for spot value—they also do forward contracts. Moreover, most major banks do not operate from day to day with completely square positions in each currency. Because of

the way different forward contracts mature each day, it is unusual for payments and receipts to balance perfectly until the traders arrange swaps to achieve that result. Because some traders take a view about the future movements of a currency, short or long positions are built up; and, because of the changing influences on market developments and traders' decisions, long or short positions can be altered any number of times each and every day.

In this kind of fluid trading environment, a bank needs to establish accounting procedures for calculating profits and losses which can handle the problem of maturity mismatches and open foreign currency positions. The principles underlying the accounting procedures are much the same from bank to bank, although specific practices vary. The first principle is that banks do not formally calculate profits or losses daily; most compute profits and losses monthly. Some banks do make these calculations more frequently for management information purposes.

The next principle is that banks calculate profits or losses on the entire foreign exchange book as of the calculation date. On any day, the book includes all spot and forward contracts which have not yet matured, along with *nostro* balances in each currency. Each contract represents a purchase or sale of a foreign currency at a specified exchange rate.

On the profit calculation date, the bank's accountants revalue the foreign exchange book. They use the latest market exchange rates, spot and forward, for each value date on which contracts are outstanding. For each contract, the difference between the current market rate for the value date of the contract and the rate specified in the contract is calculated. For example, if the bank previously bought a currency, e.g., sterling at \$1.75, and the current market rate for the relevant maturity is higher, e.g., sterling at \$1.80, there is an unrealized profit.

These calculated unrealized profits and losses are amalgamated with the realized profits or losses that accrue every day as foreign exchange contracts mature. The net profit or loss, realized plus unrealized, is then incorporated in bank operating income, reflecting the net contribution of foreign exchange trading before expenses.

To recapitulate, a bank with a large number of spot and forward contracts and possibly with open positions in one or more currencies needs a formal method of computing unrealized profits and losses at regular intervals. It uses a revaluation procedure that, in effect, measures what

the profits and losses would be if the bank covered in the market all outstanding positions that were not already covered. The revaluation procedure ensures that the bank's open positions show changes in exchange rates as they occur, rather than when open positions are eventually covered or when individual contracts mature. Periodic profit and loss calculations therefore provide bank management with ongoing insights into the performance of the trading function.

Following is an illustration of the revaluation procedure. Assume that on the revaluation date, January 15, Bank A had three outstanding contracts in its sterling book:

- A sale of £1,000,000 at \$1.75 for value March 15.
- A purchase of £3,000,000 at \$1.70 for value May 15.
- A sale of £1,000,000 at \$1.65 for value August 15.

The book is “long” £1,000,000 since purchases of sterling are greater than sales. For now, the nostro account and the calculations of realized profits and losses are left aside.

To revalue the book, the accountants find on January 15 that two-month, four-month, and seven-month forward rates in the market are \$1.80, \$1.75, and \$1.70, respectively. They proceed conceptually as if the traders were to cover the contracts at the going market rates, buying sterling to offset sales and selling sterling to offset purchases. On this basis, for the first contract, they compute an unrealized loss of \$50,000 ( $\$1.75 - \$1.80 = -\$0.05 \times \text{£}1,000,000$ ). For the second contract, they compute an unrealized profit of \$150,000 ( $\$1.75 - \$1.70 = \$0.05 \times \text{£}3,000,000$ ). For the third contract, they compute an unrealized loss of \$50,000 ( $\$1.65 - \$1.70 = -\$0.05 \times \text{£}1,000,000$ ). The net is an unrealized profit of \$50,000 which is entered on the income statement as the trading profit.

The accountant's task actually is far more complicated. A foreign exchange book of a major bank may include hundreds of outstanding contracts in a dozen or more currencies.

Value dates range from the next day to a year or more in the future. Market exchange rates are readily available for the “even” dates—one, two, three, six, twelve, and twenty-four months into the future. The Federal Reserve Bank of New York publishes such a daily series which can be used by bank accountants and examiners. But for “odd” dates, the accountant must approximate rates, possibly through a computer program that interpolates between even date quotations.

As contracts in the foreign exchange book mature, they affect the cash flow of the bank. Maturing purchase and sale contracts are treated asymmetrically. In a U.S. bank, which posts its profits and losses in dollars, maturing purchase contracts result in credits to its nostro account in that currency. Each day, the bank's accountants compute a new average acquisition rate for the nostro account based on existing holdings and all flows into the account that day. Maturing sale contracts result in debits to the nostro account. They yield a gain or loss measured against the average acquisition rate for funds available in the nostro account. The net realized profit or loss is placed in a suspense account which, at regular intervals, is incorporated into the bank's income statement along with the unrealized profits or losses resulting from the periodic revaluation of the foreign exchange book. In practice, the revaluation can be done on a worksheet as long as net positions for time periods and present market rates are known. While banks will revalue monthly and make the appropriate entries to income accounts, traders will spot-check their profitability more frequently. Examiners should understand the revaluation procedure for the necessary test checking of reported profits, as time restrictions do not normally allow for the proving of all of the bank's open positions.

To revalue the nostro accounts, which represent realized profit or loss, the net foreign currency balance is multiplied by the current spot rate and the result, or market value, is compared to the U.S. \$ equivalent on the books to determine profit or loss as shown below:

<i>Foreign Amount</i>	<i>Spot Rate</i>	<i>Market Value</i>	<i>U.S. \$ Equivalent Book Value of Ledger Accounts</i>	<i>Profit or Loss</i>
15,172	\$1.7155	26,028	21,229	+4,799

The same principle holds true when comparing market value to book, even if credit balances exist. (A market value of  $-19,055$  and a book value of  $-20,155$  would result in a profit of  $1,100$ .)

A worksheet revaluation of forward contracts, for unrealized profits, is an expansion of the forward book previously shown. All rates must be expressed in “U.S. terms.”

## FORWARD BOOK

Foreign Currency	Maturity Date	Purchases	Sales	Net Position for Period	D-Discount P-Premium Rate	Profit	Loss
England	Dec. 1–15	1 000 000	800 000	200 000	.0025 P	500	
	16–31	700 000	900 000	(200 000)	25 P		500
	Jan. 1–15	1 500 000	500 000	1 000 000	15 P	1,500	
	16–31	1 400 000	600 000	800 000	15 P	1,200	
	Feb. 1–15	1 100 000	700 000	400 000	5 P	200	
	16–28	1 400 000	400 000	1 000 000	5 P	500	
	Mar. 1–31	200 000	1 300 000	(1 100 000)	5 D	550	
	Apr. 1–30	400 000	1 600 000	(1 200 000)	15 D	1,800	
	May 1–31	300 000	900 000	(600 000)	30 D	1,800	
	June 1–30	350 000	450 000	(100 000)	45 D	450	
	July 1–31	550 000	450 000	100 000	5 P	50	
	Aug. 1–31	1 000 000	1 000 000	—	25 D	—	
	Sept. 1–30	500 000	600 000	(100 000)	0	—	
	Oct. 1–31	600 000	500 000	100 000	45 D	—	450
	Nov. 1–30	100 000	100 000	—	25 D	—	
	Dec. 1–31	100 000	200 000	(100 000)	5 P	—	50
	Totals	11 200 000	11 000 000	200 000			+7550

In completing a worksheet in the above format, the following must be kept in mind:

- A long position at a premium = profit
- A short position at a premium = loss
- A long position at a discount = loss
- A short position at a discount = profit

The \$7,550 is simply the profit that would be obtained if the forward book positions were fully liquidated at this time, i.e., purchases offset by sales. To calculate the profit, the unrealized profit from the previous month (\$6,400 in this example) must be reversed. Thus, the sterling profit for this month would be:

\$4,799	Nostro balance profit
7,550	Forward book profit (unrealized)
<u>-6,400</u>	Reversal of last month's forward book
\$5,949	Sterling profit for the month

Most automated systems will eliminate the need for manual calculations. However, the

resulting figure is only as accurate as the rates applied. As a result, examiners should test-check at least one major currency using independent rates (supplied by the Federal Reserve Bank of New York or another independent source). This should be done concurrently with the bank's own monthly revaluation. If a sizeable discrepancy results, rates and revaluation methods used by the bank should be reviewed with both management and the traders.

## DEFINING AND CONTROLLING FOREIGN EXCHANGE RISKS

Foreign exchange trading encompasses a variety of risks. Exchange rate risk, maturity gaps and interest rate risk relate to spot and forward trading. The latter two risks relate to exposures inherent in all phases of international banking.

## Exchange Rate Risk

Exchange rate risk is an inevitable consequence of trading in a world in which foreign currency values move up and down in response to shifting market supply and demand. When a bank's dealer buys or sells a foreign currency from another bank or nonbank customer, exposure from a net open position is created. Until the time that the position can be covered by selling or buying an equivalent amount of the same currency, the bank is exposed to the risk that the exchange rate might move against it. That risk exists even if the dealer immediately seeks to cover the position because, in a market in which exchange rates are constantly changing, a gap of just a few moments can be long enough to transform a potentially profitable transaction into a loss. Since exchange rate movements can readily accumulate in one direction, a position carried overnight or over a number of days entails greater risk than one carried a few minutes or hours. Again, the acid test of a good trader is to know when to take a small loss before it becomes larger.

At any time, the trading function of a bank may have long positions in some currencies and short positions in others. These positions do not offset each other, even though, in practice, some currencies do tend to move more or less together. The bank's traders recognize the possibility that the currencies in which they have long positions may fall in value and currencies in which they have short positions may rise. Consequently, gross trading exposure is measured by adding the absolute value of each currency position expressed in dollars. The individual currency positions and the gross dealing exposure must be controlled to avoid unacceptable risks.

To accomplish this, management limits the open positions dealers may take in each currency. Practices vary among banks, but, at a minimum, limits are established on the magnitude of open positions which can be carried from one day to the next (overnight limits). Several banks set separate limits on open positions dealers may take during the day. These are called "daylight" limits. Formal limits on gross dealing exposure also are established by some banks, while others review gross exposure more informally. The various limits may be administered flexibly, but the authority to approve a temporary departure from the norm is typically reserved for a senior officer.

For management and control purposes, most banks distinguish between positions arising from actual foreign exchange transactions (trading exposure) and the overall foreign currency exposure of the bank. The former includes the positions recorded by the bank's trading operations at the head office and at branches abroad. In addition to trading exposure, overall exposure incorporates all bank assets and liabilities denominated in foreign currencies including loans, investments, deposits, and the capital of foreign branches. Control of overall foreign currency exposure usually is the responsibility of a senior officer accountable to the bank's senior management.

## Maturity Gaps and Interest Rate Risk

Interest rate risk arises whenever there are mismatches or gaps in the maturity structure of a bank's foreign exchange forward book. Managing maturity mismatches is an exacting task for a foreign exchange trader.

In practice, the problem of handling mismatches is involved. Eliminating maturity gaps on a contract-by-contract basis is impossible for an active trading bank. Its foreign exchange book may include hundreds of outstanding contracts. Some will mature each business day. Since the book is changing continually as new transactions are made, the maturity gap structure also changes constantly.

While remaining alert to unusually large mismatches in maturities that call for special action, traders generally balance the net daily payments and receipts for each currency through the use of rollovers. Rollovers simplify the handling of the flow of maturing contracts and reduce the number of transactions needed to balance the book. Reliance on day-to-day swaps is a relatively sound procedure as long as interest rate changes are gradual and the size and length of maturity gaps are controlled. However, it does leave the bank exposed to sudden changes in relative interest rates between the United States and other countries, which influence market quotations for swap transactions and, consequently, the cost of bridging the maturity gaps in the foreign exchange book.

The problem of containing interest rate risk is familiar to major money market banks. Their business often involves borrowing short-term and lending longer-term to benefit from the

normal tendency of interest rates to be higher for longer maturities. But in foreign exchange trading, it is not just the maturity pattern of interest rates for one currency that counts. Rather, in handling maturity gaps, the differential between interest rates for two currencies is decisive. So the problem is more complex.

To control interest rate risk, senior management generally imposes limits on the magnitude of mismatches in the foreign exchange book. Procedures vary, but separate limits are often set on a day-to-day basis for contracts maturing during the following week or two and for each consecutive half-monthly period for contracts maturing later. At the same time, management relies on branch officers abroad, domestic money market experts, and its Economic Research Department to provide an ongoing analysis of interest rate trends.

## Credit Risk

When a bank books a foreign exchange contract, it faces a risk, however small, that the counterparty will not perform according to the terms of the contract. In both instances, there is a credit risk, although, in the foreign exchange case no extension of credit is intended. To limit credit risk, a careful evaluation of the creditworthiness of the customer is essential. Just as no bank can lend unlimited amounts to a single customer, no bank would want to trade unlimited amounts of foreign exchange with one counterparty.

Credit risk arises whenever a bank's counterparty is unable or unwilling to fulfill its contractual obligations. That happens most blatantly when a corporate customer enters bankruptcy or a bank counterparty is declared insolvent. In any foreign exchange transaction, each counterparty agrees to deliver a certain amount of currency to the other on a particular date. Every contract is immediately entered into the bank's foreign exchange book. In balancing its trading position, a bank counts on that contract being carried out in accordance with the agreed upon terms. If the contract is not liquidated, then the bank's position is unbalanced and the bank is exposed to the risk of changes in the exchange rates. To put itself in the same position it would have been in if the contract had been performed, a bank must arrange for a new transaction. The new transaction may have to be arranged at an adverse exchange rate. The trustee for a bankrupt com-

pany may perform only contracts which are advantageous to the company and disclaim those contracts which are disadvantageous.

Another and potentially more pernicious form of credit risk stems from the time zone differences between the United States and foreign nations. Inevitably, a bank selling sterling, for instance, must pay pounds to a counterparty earlier in the day than it will be credited with dollars in New York. In the intervening hours, a company can go into bankruptcy or a bank can be declared insolvent. Thus, the dollars may never be credited.

Managing credit risk is the joint responsibility of the bank's trading department and its credit officers. A bank normally deals with corporations and banks with which it has an established relationship. Dealing limits are set for each counterparty and are adjusted in response to changes in its financial condition. In addition, some banks set separate limits on the value of contracts that may mature on a single day with a particular customer. Some banks, recognizing credit risk increases as maturities lengthen, restrict dealings with certain customers to spot transactions or require compensating balances on forward transactions. A bank's procedures for evaluating credit risk and minimizing exposure are reviewed by supervisory authorities as part of the regular examination process.

## Transfer Risk

At one time or another, virtually every country has interfered with international transactions in its currency. Interference might take the form of regulation of the local exchange market, restrictions on foreign investment by residents, or limits on inflows of investment funds from abroad. Governments take such measures for a variety of reasons: to improve control over the domestic banking system, or to influence the pattern of receipts and payments between residents and foreigners. Restrictions on the exchange market or on international transactions generally are intended to affect the level or movement of the exchange rate.

Changes in regulations or restrictions usually do have an important exchange market impact. From the viewpoint of a commercial bank's foreign currency traders, most disruptive are changes in rules which interfere with the normal payments mechanism. Traders make foreign

exchange contracts on the expectation that both parties will perform according to the terms of the contract. But if government regulations change and a counterparty is either forbidden to perform as expected or is required to do something extra, then a trader might be left with an unintended open position or an unintended maturity mismatch. As described in the previous section, dealing with unintended long or short positions can be costly.

Other changes in official regulations do not in the first instance, affect the payments mechanism, but they do influence international investment transactions. Consequently, when one of the factors affecting the buying or selling of a currency changes, the exchange rate is likely to respond. Currency traders usually try to limit open positions and maturity gap mismatches, whenever modifications in official regulations appear likely. Nevertheless, changes in controls often are unpredictable; and unanticipated changes in regulations can spark significant exchange rate response.

Monitoring and responding to changing official exchange controls abroad has to be done by a well-run foreign exchange trading function. Most U.S. banks have judged that the simplest approach is to avoid trading in those currencies for which the market is heavily regulated. This decision is reflected in turnover statistics which show that trading is concentrated in the major currencies subject to the fewest controls; generally the euro, Canadian dollar, British pound sterling, Swiss franc, and Japanese yen.

## POLICY

The relative importance of each of those risk determinants varies with each currency traded and with the country of each counterparty. Senior bank management must fully understand the risks involved in foreign exchange and money market operations and must establish, in writing, its goals and policies regarding those risks. Management must be able to defend logically the basis upon which such policies are formed. It is imperative that responsible officers, traders, clerks and auditors fully understand the intent as well as the detail set forth in those directives.

At a minimum, policies should define dealing limits and reporting requirements as well as

accounting and audit and control systems to provide for proper surveillance over those limits and exceptions thereto.

Limits must be established for overnight net positions in each currency. Depending on the size of the limits and the manner in which they are calculated, a smaller aggregate position limit for all currencies may be desirable. An aggregate limit should not permit the netting of short against long positions, but should require that they be added to determine conformance to that limit. Many U.S. banks consider whether to establish daylight (intraday) position limits only if efficient computerization and input systems are in effect to incorporate each trade into the appropriate currency position at nearly the precise moment it is transacted.

Gap (net inflow and outflow) limits must be instituted to control the risk of adverse rate movement and liquidity pressures for each currency for each daily, weekly, and biweekly future time frame designated in the bank's maturity reports. Such limits might range from stated absolute amounts for each time frame to weighted limits that emphasize increasing rate movement exposure applicable to the relative distance into the future in which the gap appears.

Aggregate trading and placement limits must be established for each customer, based primarily on the amount of business considered to be appropriate to its creditworthiness and, secondly, on the volume of its foreign currency needs. In addition, absolute sub-limits should be placed upon the amount of that customer's business that may be settled on one day. Should the customer be unable to meet obligations on one day, the trader will:

- Be forewarned against delivery prior to receipt of customer funds on the remaining contracts outstanding, and
- Have an opportunity to determine whether alternate cover must be obtained to meet third-party transactions that may initially have provided cover for the remaining transactions with that customer.

It is difficult to monitor aggregate volume limits effectively and ensure compliance with settlement limits for a large number of customers. An effective settlement limit program for at least those relationships that possess a greater potential for late delivery or default should be enacted by senior management.

## REPORTS

Properly designed reports are the most important supervisory tool available to management. They must be prepared in a concise, uniform, and accurate manner and submitted punctually. Management should receive daily net position reports for each currency traded. Normally, position reports should include all foreign currency balance sheet items and future contracts as well as afterhour and holdover transactions, excepting fixed assets and equity investments. The hedging of those investments is usually a management decision outside the normal responsibility of the traders. The reports should be prepared by the foreign exchange and money market bookkeeping section and reconciled daily to the trader's blotter. In the event that formal position reports cannot be submitted at the end of a business day, management should be apprised of the traders estimated position at the end of each day and especially before weekends and holidays.

Gap or maturity reports are essential to the proper management of a bank's liquidity in each foreign currency and significant maturity gaps may affect overall liquidity. Those reports should show daily gaps for at least the first two weeks to one month. Beyond that time, gap periods of a maximum of two weeks each are preferred. Gap reports are generally accurate only for the day on which they are prepared. Therefore, it is essential that banks have the capability to produce detailed management reports daily. Loans, deposits, and future contracts, as well as commitments to take or place deposits should be reflected in the periods in which they are scheduled for rollover or interest adjustment. In most instances, an additional report showing those items at final maturity is desirable in analyzing the bank's medium- and longer-term dependence on money market funding sources.

Exception reports must be promptly generated upon the creation of excesses to position limits, gap limits, and customer trading and settlement limits. Excesses over any established limits should conform to overall policy guidelines and should receive prior approval by the responsible supervisory officers. If prior approval is not possible, evidence of subsequent officer concurrence or disagreement as well as any corrective action should be available for audit review and management records.

## REVALUATION AND ACCOUNTING SYSTEMS

Revaluation and accounting systems should be in place to accurately determine actual as well as estimated future profits and losses and to present them in such a manner as to facilitate proper income analysis by management, bank supervisory personnel, and the public. A bank's revaluation procedure should be test-checked at the time of monthly revaluation using independently obtained rates. While methods and systems may vary to some degree within banks, all revaluation systems should incorporate the following two aspects:

- Actual realized profit or loss as determined by applying current spot rates to balance sheet accounts as well as contracts of near maturities. Adjustments to the local currency book values would either be allocated and posted to each of the applicable local currency ledger accounts or, for short interim periods, be charged to a separate foreign exchange adjustment account with an offset to the profit and loss account.
- Unrealized (estimated future) profit or loss on future transactions as determined by applying the appropriate forward rates to the net positions shown for each future period appearing in the bank's gap or maturity reports. An account such as "estimated profit (loss) on foreign exchange—futures" should be charged or credited for the amount of the adjustment with an offset to the profit and loss account. Provided that the amount of that adjustment is the difference between the existing forward rates and the actual contract rates, each month's entries merely involves reversing the adjustment from the prior revaluation and entering the new figures.

## SPECIALIZED TRANSACTIONS

### Financial Swaps

A financial swap is the combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. It is merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange

is made and the forward contract matures. The swap is the simple identification of one transaction contracted at the spot rate with another transaction contracted at the forward rate to establish the exchange cost or profit related to the temporary movement of funds into another currency and back again. That exchange (swap) profit or cost must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. For example, the true yield of an investment for 90 days in United Kingdom Treasury bills cannot be determined without having considered the cost or profit resulting from the swap needed to make pounds sterling available for that investment. Likewise, the trading profits or losses generated by the trader cannot be determined if financial swap profits and expenses are charged to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

## Arbitrage

As it pertains to money markets and foreign exchange, arbitrage may take several forms. The creation of an open position in a currency in anticipation of a favorable future movement in the exchange rate, in addition to being speculative, is sometimes referred to as “arbitrage in time.” Buying a currency in one market and simultaneously selling it for a profit in another market is called “arbitrage in space.” Slightly more involved is the practice of interest arbitrage which involves the movement of funds from one currency to another so they may be invested at a higher yield. The real yield advantage in such a situation is not determined merely by the difference in interest rates between the two investment choices, but rather by subtracting the cost of transferring funds into the desired currency and back again (the swap cost) from the interest differential. For example, there is no arbitrage incentive involved in swapping from dollars into the other currency at a 60 point per month discount (swap cost) which exactly offsets the 3 percent gain in interest. However, should the swap rate move to 40 points per month (or 480 points per year), the investment might become attractive. This can be tested by converting the swap rate to an annual percentage rate:

$$\frac{\text{Discount or Premium} \times 360 \times 100}{\text{Spot rate} \times \text{No. of days of future contract}} = \% \text{ P.A.}$$

$$\frac{.0040 \times 360 \times 100}{2.4000 \times 30} = 2\% \text{ P.A.}$$

This results in a true yield incentive of 1 percent, 3 percent less the swap cost of 2 percent.

Unless the bank’s accounting system can identify swap costs or profits and allocate them to the investments for which they were entered, both the earnings on those investments and the earnings upon which the trader’s performance are measured will be misstated.

## Options

Option contracts permit a bank to contract to buy from or sell to a customer when that customer can only generally predict the dates when the currency will be required. The option contract specifies the dates, and the rate cited is that which, in the judgment of the trader at the time of making the contract, contains the least exposure for the bank. This type of contract is commonly requested by commercial customers who wish to cover drafts drawn under letters of credit denominated in a foreign currency. Such contracts involve more risk as there is no way for the bank to acquire a precisely matching cover.

## Compensated Contracts

There are occasions when both parties are agreeable to altering the terms of an existing contract. Such alterations should be approved by a bank officer without responsibilities in the trading room and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original instructions and terms.

## OTHER RELATED MATTERS

### Departmental Organization and Control

It is imperative that there be a distinct separation

of duties and responsibilities between the trading and the accounting and confirmation functions within the department. Many opportunities exist to avoid established limits and policies or for personal financial gain, whether by speculating beyond loosely controlled limits, concealing contracts because of poor confirmation procedures or by simple fraud. Periodic audits and examinations are no substitute for the existence of sound safeguards.

### Supervision of Branches and Subsidiaries

Whether a bank maintains central control over all foreign-exchange and money market activi-

ties at the head office or elects to decentralize that control, the policies, systems, internal controls, and reporting procedures should not differ among separate offices within the bank.

The bank should be apprised of its worldwide positions by daily summary reports. Detailed net position and maturity gap reports should be received periodically in order to prepare consolidated positions, as required, and to monitor individual unit trading volume and funding methods.

# International—Foreign Exchange Examination Objectives

Effective date March 1984

## Section 7100.2

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1. To determine if the policies, practices, procedures and internal controls regarding foreign exchange activities are adequate.
2. To determine if bank officers, traders and clerks are operating within the established guidelines.
3. To determine the extent of risk attributable to net open positions, maturity gaps and counterparty credit weakness.
4. To determine the scope and adequacy of the audit function.
5. To determine if the revaluation and accounting systems are adequate and accurately reflect the results of the trading operation.
6. To determine compliance with laws and regulations.
7. To initiate corrective action when policies, practices, procedures or internal controls are deficient, or when violations of laws or regulations have been noted.

# International—Foreign Exchange Examination Procedures

Effective date March 1984

## Section 7100.3

1. If selected for implementation, complete or update the foreign exchange section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors, and determine if appropriate corrections have been made.
4. Obtain a trial balance, including local currency book values, of customer spot and future contract liabilities by customer and by maturities and:
  - a. Agree or reconcile balances to appropriate subsidiary controls and to the general ledger.
  - b. Review reconciling items for reasonableness.
5. Review foreign currency and appropriate local currency subsidiary control ledgers to determine that for each local currency entry there is an accompanying foreign currency entry unless they represent:
  - a. Brokerage charges to the local currency ledger.
  - b. Profit and loss adjustments to the local currency ledger.
  - c. Correction of errors in either ledger.
6. Provide liability and other information on common borrowers to the examiner assigned to “International—Loans and Current Account Advances.”
7. Identify those contracts with counterparties who are affiliates of or otherwise related to the bank, its directors, officers, employees, or major shareholders, and
  - a. Compare the contracted rates with available rates for the same transaction date or with other similar contracts entered as of the same transaction date.
  - b. Investigate any instances involving off-market rates.
8. Perform an independent revaluation of at least one major currency using rates obtained from independent sources, and compare results to the accounting department’s monthly foreign exchange profit and loss entries.
9. Check the most recent revaluation workpapers and resultant accounting entries to determine that:
  - a. Foreign currency amounts and book values were properly reconciled to subsidiary ledger controls.
  - b. Rates used are representative of market rates as of revaluation date.
  - c. Arithmetic is correct.
  - d. Profit and loss results are separately recorded and reported to management for:
    - Realized profit or loss, i.e., that which is determined through the application of spot rates.
    - Unrealized (estimated future) profit and loss, i.e., that which is determined through the application of forward rates.
  - e. Financial swap related assets, liabilities and future contracts are excluded from the normal revaluation process so that the results identified in step 9d reflect more accurately the trader’s outright dealing performance.
  - f. Financial swap related costs and profits are:
    - Amortized over the life of the applicable swap.
    - Appropriately accounted for as interest income and expense on loans, securities, etc. Test financial swap income and expense calculations and verify the accounting entries.
10. Review workpapers for selected revaluations performed since last examination. Test-check and, if satisfied that they are accurate,
  - a. Analyze combined realized earnings to determine that profits are commensurate with risks taken.
  - b. Analyze monthly unrealized revaluation results (forecasts) to determine that:
    - The resulting amount for the last revaluation, if loss, is not large.
    - An increasing loss trend over previous revaluations does not exist. (Although month-to-month variations are not uncommon, an increasing unrealized loss trend could indicate that a trader is

- caught in a loss position and is pursuing a notion that a negative trend in the exchange rate for that currency will reverse and, if combined with an ever multiplying increase in volume, might eventually be able to repay accumulated losses.)
11. Obtain the percentage of total contracts outstanding (dollar value of purchases plus sales that are with corporate customers). Analyze this percentage in regard to trend and comparison, if possible, to banks with similar trading volume. Ascertain if corporate volume is commensurate with written policy in regards to purpose and scope of the foreign exchange trading function.
  12. Determine compliance with laws and regulations pertaining to foreign exchange activities by performing the following for Foreign Currency Forms FC-1, FC-1a, FC-2, and FC-2a:
    - a. Obtain the most recently prepared monthly and weekly reports and review for accuracy.
    - b. Select random bank-prepared daily net position reports for Wednesdays and month-end business days and test to see that:
      - Reports are being filed as required.
      - Reports are accurate.Be aware of instances in which net positions are generally large but reduced as of Wednesday and month-end reporting dates.
  13. Discuss with appropriate officers and prepare in appropriate report format:
    - a. Net position schedules.
    - b. Maturity gap schedules.
    - c. Frequent or sizeable excesses over any established limits.
    - d. Any limits deemed excessive relative to:
      - Management's policy goals regarding the nature and volume of business intended.
      - The bank's capital structure.
      - The creditworthiness of trading counterparties.
      - Individual currencies which are subject to or are experiencing relatively sporadic rate changes.
      - Individual currencies for which limited spot and future markets exist.
      - Experience of traders.
      - The bank's foreign exchange earnings record.
    - e. The absence of any limits deemed appropriate in present and foreseeable circumstances.
    - f. Customers whose obligations are otherwise previously classified or intended to be criticized.
    - g. Foreign exchange contracts which, for any other reason, are questionable in quality or ultimate settlement.
    - h. Violations of laws and regulations.
    - i. Deficiencies in internal controls.
    - j. Other matters regarding the efficiency and general condition of the foreign exchange department.
  14. Update the workpapers with any information that will facilitate future examinations.

# International—Foreign Exchange Internal Control Questionnaire

Effective date March 1984

## Section 7100.4

A review of the bank's internal controls, policies, practices and procedures regarding foreign exchange trading is essential to ensure no excessive risk or exposures exist. The bank's systems should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk are particularly significant and require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its responsibilities, adopted written policies governing:
  - a. Trading limits, including:
    - Overall trading volume?
    - Overnight net position limits per currency?
    - Intra-day net position limits per currency?
    - Aggregate net position limit for all currencies combined?
    - Maturity gap limits per currency?
    - Individual customer aggregate trading limits, including spot transactions?
    - Written approval of excesses to above limits?
  - b. Segregation of duties among traders, bookkeepers and confirmation personnel?
  - c. Accounting and revaluation procedures?
  - d. Management reporting requirements?
2. Do policies attempt to minimize:
  - a. Undue pressure on traders to meet specific budgeted earnings goals?
  - b. Undue pressure on traders, by account officers, to provide preferred rates to certain customers?
- \*3. Are traders prohibited from dealing with customers for whom trading lines have not been established?
4. Are all personnel, except perhaps the head trader, prohibited from effecting transactions via off-premises communication facilities?
5. Is approval by a non-trading officer required for all compensated transactions?
6. Do credit approval procedures exist for settlement (delivery) risk either in the form of settlement limits or other specific management controls?
7. Does a policy procedure exist to ensure that, in case of an uncertain or emergency situation, the bank's delivery will not be made before receipt of counterpart funds?
8. Do the above policies apply to all branch offices as well as majority-owned or controlled subsidiaries of the bank?
9. Does the bank have written policies covering:
  - a. Foreign exchange transactions with its own employees?
  - b. Foreign exchange transactions with members of its board of directors?
  - c. Its traders' personal foreign exchange activities?
  - d. Its employees' personal business relationships with foreign exchange and money brokers with whom the bank trades?
- \*10. Are the above policies understood and uniformly interpreted by all traders as well as accounting and auditing personnel?

### TRADING FUNCTION

11. Is a trader's position sheet maintained for each currency traded?
- \*12. Does management receive a trader's position report at the end of each trading day?
- \*13. Does the trader's position report reflect the same day's holdover and after-hours transactions?
14. Are trader's dealing tickets prenumbered?
  - a. If so, are records and controls adequate to ascertain their proper sequential and authorized use?
  - \*b. Regardless of whether or not prenumbered,
    - Are dealing tickets time date stamped, as completed, or
    - Are dealing tickets otherwise identified with the number of the resultant contract to provide a proper audit trail?

## ACCOUNTING AND REPORTING

- \*15. Is there a definite segregation of duties, responsibility and authority between the trading room and the accounting and reporting functions within the division and/or branch?
16. Are contract forms prenumbered (if so, are records and controls adequate to ensure their proper sequential and authorized use)?
17. Are contracts signed by personnel other than the traders?
- \*18. Are after-hours or holdover contracts posted as of the dates contracted?
- \*19. Do accounting personnel prepare a daily position report, for each applicable currency, from the bank's general ledger and:
- Do reports include all accounts denominated in foreign currency?
  - Are those reports reconciled daily to the trader's position reports?
  - Are identified or unreconciled differences reported immediately to management and to the head trader?
  - Are all counterparty non-deliveries on expected settlements reported immediately to management and to the head trader?
- \*20. Are maturity gap reports prepared for liquidity and foreign exchange managers at least biweekly to include:
- Loans and deposits reflected in the appropriate forward maturity periods along with foreign exchange contracts?
  - Loans, deposits and foreign exchange contracts (specify whether reflected in the maturity periods in which they fall due or in which they are scheduled for rollover \_\_\_\_\_)?
  - Commitments to accept or place deposits reflected in the appropriate maturity periods by both value and maturity dates?
  - All those items (specify whether as of the day on which they mature or bi-weekly or monthly maturity periods \_\_\_\_\_)?
  - All those items as of the day on which they mature, if necessary, i.e., in the event of a severe liquidity situation?
- \*21. Does the accounting system render excesses of all limits identified at step 1 immediately to appropriate management and is officer approval required?
- \*22. Are local currency equivalent subsidiary records for foreign exchange contracts balanced daily to the appropriate general ledger account(s)?
- \*23. Are foreign exchange record copy and customer liability ledger trial balances prepared and reconciled monthly to subsidiary control accounts by employees who do not process or record foreign exchange transactions?
24. Do the accounting and filing systems provide for easy identification of "financial swap" related assets, liabilities and future contracts by stamping contracts or maintaining a control register?

## CONFIRMATIONS

25. Is there a designated "confirmation clerk" within the accounting section of the division or branch?
- \*a. Incoming confirmations:
- Are incoming confirmations delivered directly to the confirmation clerk and not to trading personnel?
  - Are signatures on incoming confirmations verified with signature cards for:
    - Authenticity?
    - Compliance with advised signature authorizations of the counterparty?
  - Are all data on each incoming confirmation verified with file copies of contracts to include:
    - Name?
    - Currency denomination and amount?
    - Rate?
    - Transaction date?
    - Preparation date if different from transaction date?
    - Maturity date?
    - Delivery instructions, if applicable?
  - Are discrepancies directed to an officer apart from the trading function for resolution?
  - Is a confirmation discrepancy log or other record maintained to reflect the identity and disposition of each discrepancy?

- Are telex tapes retained for at least 90 days as ready reference to rates and delivery instructions?
- \*b. Outgoing confirmations:
  - Are outgoing confirmations mailed/telexed on the day during which each trade is effected?
  - Are outgoing confirmations addressed to the attention of persons other than trading personnel at counterparty locations?
  - Does the accounting and/or filing system adequately segregate and/or identify booked contracts for which no incoming confirmations have been received?
  - Are follow-up confirmations sent by the confirmation clerk if no corresponding, incoming confirmation is received within a limited number of days after the contract is effected (if so, specify \_\_\_\_\_)?
  - Is involvement by the auditing department required if no confirmation is received within a limited number of days after the transmittal of the second request referred to above (if so, specify \_\_\_\_\_)?
  - Are confirmation forms sent in duplicate to customers who do not normally confirm?
  - Are return copies required to be signed?

## REVALUATIONS

- \*26. Are revaluations of foreign currency accounts performed at least monthly?
  - a. Does the revaluation system provide for segregation of and separate accounting for:
    - Realized profits and losses, i.e., those which are determined through the application of spot rates?
    - Unrealized profits and losses, i.e., those which are determined through the application of forward rates?
  - b. Are financial swap related assets, liabilities and future contracts excluded from

- the revaluation process so that the results identified in step 26a above more accurately reflect the trader's outright dealing performance?
- c. Are financial swap costs and profits:
  - Amortized over the life of the applicable swap?
  - Appropriately accounted for as interest income and expense on loans, securities, etc?
- d. Are rates provided by, or at least verified with, sources other than the traders?

## OTHER

- \*27. Is the bank's system capable of adequately disclosing sudden increases in trading volume by any one trader?
- 28. Do such increases require officer review to insure that the trader is not doubling volume in an attempt to regain losses in his or her positions?
- 29. Does the bank retain information on, and authorizations for, all overdraft charges and brokerage bills within the last 12 months?
- 30. Does an appropriate officer review a comparison of brokerage charges, monthly, to determine if an inordinate share of the bank's business is directed to or handled by one broker?

## CONCLUSION

- 31. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 32. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

# International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Effective date September 1992

## Section 7110.1

The prospects for full LDC debt repayment decreased during the mid-1980s because of depressed commodity prices and inflated interest rates. The market value of public and private sector LDC loans fell sharply below book value to the point where those loans became deeply discounted. A secondary market for trading LDC debt evolved and reached a degree of maturity in 1987 when banks significantly increased their loan loss reserves for their exposures to LDCs. Financial institutions in the United States and overseas, including commercial, merchant and investment banks, began to actively purchase, sell, swap and rent debt obligations of less developed countries for their own account and as intermediaries for others. U.S. multinational banks with significant LDC loan exposures established LDC trading units which initially had the primary responsibility to decrease the banks' LDC portfolios. As the secondary market matured, these units not only traded for their own accounts but became market makers and/or active participants in purchasing, selling, swapping and renting LDC debt. An options market based on LDC debt also is emerging.

The LDC debt market, once dismissed as illiquid, has evolved from a trickle of activity between 1985 through 1988, to a turnover of approximately \$100 billion during 1990. This momentum is expected to continue as participants in this market have realized the potential for generating substantial profits in trading LDC debt. The majority of this paper is Latin American, followed by Eastern European and African obligations. Debt of approximately 30 countries in 300 instruments may be handled by an active participant.

The LDC trading arena includes a broad range of counterparties. Although multinational banks with significant LDC debt exposures are the most active participants in the market, the number of intermediaries and principals has grown substantially. International financial institutions, corporations, high net worth individuals and public sector entities are primarily engaged in buying, selling and renting LDC debt for their own account.

The price of LDC paper, which is almost always at a discount from face amount, may vary widely, depending on the issuer and maturity of the instrument and the country of risk.

Prices (and liquidity) in the LDC debt market are influenced by a multitude of factors such as the ability/intent of public and private sector borrowers to service the debt, availability of debt-equity exchange programs, anticipated refinancing of existing debt programs and the underlying political and economic conditions in the developing countries.

Banks generally participate in this market to decrease their LDC exposures; however, some banks are also motivated to:

- Generate trading profits from the spread between the bid and offer prices
- Produce fee and commission revenues from acting as intermediaries for principals and brokers
- Participate in swap programs to facilitate debt/equity market development

Pricing, liquidity, potential conflicts of interest, violation of U.S. and foreign country laws and operational inefficiencies are the major problems faced by banks which are active market participants. The lack of liquidity in the secondary market for LDC paper could present a variety of risks to market participants. In the absence of depth in the market, the judgement of the trader is a significant factor in determining the current price of thinly traded issues. The reliance on one individual to determine prices and using those amounts to revalue the position, could result in under or overstating the profit and loss and the valuation of the position itself. A conflict of interest could result in potential future liability if there is no clear segregation of duties and responsibilities between a bank's trading in LDC assets and its role on debt renegotiation committees.

Access to LDC debt rescheduling information could give a bank unfair advantage over other creditor banks, which do not participate in the restructuring process. Another concern is the potential for a bank or its employees to knowingly or inadvertently violate U.S. or foreign country laws or aid or abet violations by its customers or trading partners. It is clear that banks have a responsibility to determine that they deal only with reputable counterparties. The relative newness of the market and the absence of industry guidelines pose challenges to both bank managements and the bank supervisory agencies.

# International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

## Examination Objectives

Effective date September 1992

## Section 7110.2

The objectives of conducting an examination of LDC asset purchases, sales, trading, swaps, rentals and options should include the following:

1. To determine if LDC asset purchases, sales, trading, swaps, rental and options policies, procedures and internal controls are adequate.
2. To evaluate the ability of the bank's reporting system to adequately monitor compliance to established policies, procedures and limits.
3. To review the bank's reporting system to determine whether it is adequate and effective.
4. To ascertain, to the extent possible, whether LDC trading activities are in compliance with applicable U.S. and local foreign laws.
5. To determine the extent of involvement by committees responsible for LDC trading activity in strategy and planning. For example, have contingency plans been developed if the need arises to liquidate a portfolio of LDC paper.
6. To identify potential conflicts of interest liability between those on committees for debt renegotiations or those acting as agents for the debtor country and those on the portfolio sales personnel and LDC debt traders.
7. To determine whether accounting procedures that have been established properly identify and account for loan sales, purchases, swaps, rentals and other LDC trading activity. Compare these accounting procedures to industry practices.
8. To ascertain that outstandings and traders' positions are reconciled to the official records of the bank.
9. To evaluate the LDC asset purchases, sales, trading, swaps or rentals for profitability.
10. To review the revaluation process utilized in determining profitability.
11. To determine the adequacy of the bank's risk management as it relates to LDC activities. Evaluate the bank's ability to monitor and control the following risks:
  - a. Market risk
  - b. Credit risk
  - c. Settlement risk
  - d. Liquidity risk
  - e. Operational risk
  - f. Legal risk
12. To review and assess the adequacy of the audit coverage with respect to the frequency and scope of the audit program, experience of auditors, quality of audit reports and effectiveness of management follow-up. Determine the extent of the outside accountants involvement in reviewing these activities.
13. To determine if sufficient legal documentation exists to establish an enforceable agreement, and to ascertain the nature of and purpose behind the underlying transaction.
14. To review the bank's procedures for conducting due diligence on nonbank parties.
15. To determine the sufficiency of the bank's transaction files.
16. To determine if the bank allows sales, borrowing or substitutions from its loan portfolio to its trading positions. If yes, how is the pricing on the loan portfolio done? Does the bank have the proper accounting and tracking procedures in place?
17. To review any unusual charges/fees and any split of fees or unusual destination of a payment.
18. To review margin lending practices and policies of banks offering financing to customers dealing in LDC debt.
19. To review bank's policies and procedures regarding traders' ability to trade in LDC debt for their own personal account to ensure that adequate controls are in place to avoid conflicts of interest and diversion of bank's corporate opportunities to traders' personal benefit.

# International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

## Examination Procedures

Effective date September 1992

## Section 7110.3

An examination of a bank's LDC asset purchases, sales, trading, swaps, rental, and options program should focus on written policies, accounting, management reporting, conflict of interest, risk management, and internal controls. In addition, the examiners should address the general nature, volume and importance of these activities.

1. Evaluate the adequacy of the bank's written policies regarding its LDC trading activity and determine whether:
  - a. The objectives, strategy and philosophy adhere to those approved by the bank's board of directors.
  - b. All documentation and legal requirements (both local and foreign) regarding this activity have been addressed.
  - c. An approval process has been established to execute unusual or complex transactions in LDC paper that lacks liquidity or has some unusual feature.
  - d. The policy stipulates the options available if the need arises to remove the asset from inventory.
2. Review the bank's accounting policy for LDC transactions.
  - a. Review the accounting and reporting guidelines to assure that all aspects of this activity are captured on the books of the bank.
  - b. Review the subsidiary ledgers and reconcile these with the general ledger and contingent accounts.
  - c. Reconcile the traders position sheet with the general ledger accounts.
  - d. Review the accounting procedures governing the bank borrowing LDC debt from its own portfolio and purchasing or borrowing from a third party.
  - e. Determine if the revaluation process is conducted separately from the trading process and that the resultant gains or losses are properly recorded.
3. Determine whether the bank has addressed the "conflict of interest" issue sufficiently, so that trading activities are not being influenced by other areas of the bank that may be negotiating debt restructuring activities or that may have provided advice to such country on financial or economic matters. Are the same individuals participating as members of a debt renegotiating committee or acting in an agency capacity for the debtor country also involved in or communicating with those trading, swapping and renting LDC debt?
  - a. Does the policy address all the roles that the bank performs? Has management established procedures to identify the responsibility of renegotiating committee members, agency personnel, portfolio sales personnel and LDC debt traders?
4. Review the bank's procedures to ensure that it is complying with local and sovereign laws.
  - a. Is the bank aware of local and foreign laws governing the trading of a particular country's debt? Are there records demonstrating that legal personnel are reviewing transactions to determine compliance with U.S. and foreign laws? To what extent is this information disseminated to traders?
  - b. Is the bank assuring itself that trading partners are not violating these laws or are using the bank to circumvent compliance with applicable laws and regulations?
5. Evaluate management's understanding of the risks associated with LDC asset purchases, sales, trading, swaps, options and rentals. Determine whether all risks have been considered and assess management's ability to monitor and control them. The following risks should be considered:
  - a. *Market Risk*—The relevant risk interval for counterparty exposure is the time period from trade date to final settlement date. The exposure is a function of the change in the price during the risk interval. Determine how the bank monitors and controls its exposure to an increase in price, if it is buying, and decrease in price, if selling.
  - b. *Credit Risk*—Does the bank require credit approval from appropriate lending officers for each counterparty? Review counterparty credit lines for proper approval.

- Review margin lending practices as related to LDC debt sales.
- c. *Settlement Risk*—While it occurs only when purchasing LDC assets, examiners should determine how the bank protects itself from this risk.
  - d. *Liquidity Risk*—Have restrictions been placed on dealing in LDC debt which is not actively traded?
  - e. *Operating Risk*—Review the bank’s policies and procedures for deficiencies. Assure that all operating groups supporting this activity are adhering to established guidelines.
  - f. *Legal Risk*—Has counsel reviewed all segments of this activity from a legal perspective?
6. Determine whether the bank’s LDC trading activities are subject to regular audits.
    - a. Obtain copies of all recent audits and review their findings;
    - b. Determine whether the audit procedures covering these activities are sufficiently comprehensive; and
    - c. Determine whether management has taken appropriate action to resolve significant audit concerns.
  7. Evaluate the bank’s internal control policies and procedures with emphasis on:
    - a. Are traders’ lines and LDC debt limits established by country, type of paper and customer?
    - b. Are limits established by credit officers who are independent of the LDC trading function?
    - c. Determine that exceptions to established limits have been properly reported and approved.
  8. Evaluate the policies and procedures governing traders’ behavior:
    - a. What type of controls are in place with regard to after hour trading?
    - b. Describe the bank’s procedures for recording phone conversations. Are traders permitted to override the recording devices? How long are these recordings retained?
    - c. Describe the bank’s policy regarding traders’ remuneration.
  - d. What types of procedures and policies have the bank implemented to address self-dealing in LDC debt by traders?
  - e. In what manner are the traders educated about the bank’s policies and procedures?
9. Describe the type of LDC transactions entered into by the bank:
    - a. Does the bank engage in fronting (i.e., sales of participations, etc.) transactions? When engaging in fronting transactions, does the bank conduct the proper legal analysis regarding whether such transaction would violate any U.S. or foreign laws or restructuring agreements? Does the bank inquire as to the customer’s purpose for acquiring LDC debt in fronting transactions?
    - b. Does the bank engage in parking transactions through a third party or another banking unit? Does the bank permit other financial institutions to park debt with it?
  10. Evaluate the private banking unit/group’s involvement in LDC transactions:
    - a. How are the private banking clients obtained?
    - b. What types of LDC transactions does the bank enter into for its private banking clients? Does the bank inquire as to purpose of transactions entered into for private banking clients?
    - c. What type of scrutiny is performed to assure that the bank “knows its private banking clients?”
  11. Describe the types of fees which the bank pays when engaging in LDC transactions:
    - a. What are the amounts of broker fees? Are these fees easily determinable? Are these fees in line with the industry practices?
    - b. Does the bank have any other type of fee arrangements (i.e., specially negotiated fees, partnerships, etc.)?
    - c. Has the bank diversified its use of brokers adequately?
  12. Evaluate broker involvement in the LDC trading activity and review the fee structure on transactions.

# International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Effective date September 1992

Section 7110.4

## FIRST-DAY LETTER

Please provide the following information regarding your bank's LDC asset sales, purchases, swaps, options, and rental programs as of (*examination date*).

1. A complete inventory, broken down by country, of all LDC paper held in the trading account and the investment account.
2. A listing of all sales/purchases of LDC paper that identifies the assets or commitments sold/bought and inventory by (a) obligor, (b) face amount, (c) maturity, (d) price, (e) closing date, (f) counterparty names, and (g) the names and address of the assignor and assignee.  
Sales from the bank's own portfolio should be reported separately from transactions of the LDC trading unit.
3. Listing of all rentals of and options held on LDC paper.
4. A copy of the bank's specific policies and procedures for LDC asset purchases, sales, swaps, options and rentals.
5. A copy of all rules of conduct, procedures and policies governing LDC activities.
6. An organizational chart and the names and titles of individuals designated as responsible for LDC trading activities.
7. A listing and brief description of all management information reports covering these activities and copies of these reports.
8. Describe accounting policies and operating procedures if the LDC trading unit borrows from the bank's loan portfolio to effect delivery or borrows/lends LDC debt from/to third parties.
9. Information broken down by trading location/profit center showing the volume of LDC assets purchased, sold, swapped and rented during the two prior years, the current year to date and a projection of the volume of activity for the balance of this year and next year.
10. A listing of all limits, including the bank's overall inventory limit, country limits, type of paper limit, customer settlement limit and trader limits. Indicate the policy regarding the review dates of limits. A list of any exception reports to these limits and management's responses to exceptions.
11. A listing of principal counterparties and approved counterparty lines.
12. A list of brokers used and indicate the approximate percentage of total business conducted with each and the fees paid to such brokers.
13. Copies of any standard documents used by the bank in its LDC asset sales, purchases, swaps and rentals.
14. A copy of trading policies. If the bank is a market maker, list the type of LDC debt in which it makes a market.
15. A listing of all general ledger contingency and memoranda accounts, income and expense accounts to record LDC asset sales, swaps and renting transactions.
16. Income and expenses of LDC trading activities for the two prior years and year-to-date.
17. Copies of the most recent audit reports conducted by both the internal and external auditors, including management responses on the bank's LDC asset trading activities.
18. A copy of the internal and external audit programs and procedures used for the audits of these activities.
19. If conducted outside of the United States, any information submitted to local regulatory authorities regarding the LDC trading function should be requested.
20. Copies of any legal opinions rendered on specific transactions and a list of any pending litigations.
21. A copy of the industry association's rules and regulations.