

Funds management is an essential element of sound planning and financial management for any financial institution. A sound basis for evaluating funds management requires understanding the branch, its customer mix, the nature of its assets and liabilities, and its economic and competitive environment. No single theory can be applied universally to all branches. The purpose of funds management is to ensure adequate liquidity and effectively manage the spread between interest earned and interest paid. Therefore, funds management has two components: liquidity and interest rate risk management. This section primarily addresses liquidity. Interest rate risk management is addressed in Section 3210 of this manual, and should be read in conjunction with this section.

LIQUIDITY

Liquidity is defined as the ability to meet asset and liability obligations without delay, including the funding of loan commitments. In a sound liquidity management system, it is essential for a branch to provide for fluctuations in its balance sheet and meet immediate or day-to-day obligations as opposed to providing funds for long-term growth.

A branch generally has both internal and external sources of liquidity. Internal sources of liquidity include short-term, high-quality assets that are readily convertible to cash at a reasonable cost. External sources of liquidity include borrowings from related offices of the foreign banking organization (FBO), other financial institutions, and overnight or short-term depositors.

The price of liquidity is a function of general market conditions and the market's perception of the FBO. Generally, the higher the risk profile of the FBO, the higher the FBO's cost of funds and the greater its need to meet liquidity demands through the management of its liabilities. Generally, the market perception of the branch can be no better than the market perception of the FBO.

BRANCH/FBO RELATIONSHIP

Liquidity at a branch is closely integrated with

that of the FBO. While a branch, on a stand alone basis, may be able to obtain sufficient funding at a reasonable cost (by either increasing funding sources or converting assets to cash), from a market standpoint, there is no distinction between the branch and the FBO. Even if all of the branch's assets consisted of high-quality, liquid securities, liquidity would still be influenced by the market perception of the FBO as a whole.

In evaluating funds management and liquidity, the examiner should begin with an understanding of the FBO's current financial situation and be familiar with any potential liquidity concerns that could affect the branch.¹ Generally, if the FBO is in sound financial condition and has satisfactory market ratings, the evaluation of liquidity at the branch will be a lesser concern. In such a case, the examiner should limit the analysis of liquidity to (1) reviewing information supporting the adequacy of liquidity at the FBO, (2) developing a thorough understanding of the branch's funds management and liquidity profile, and (3) reviewing how the branch's funding and liquidity are guided and monitored, either directly or indirectly, by the head office and/or a U.S. regional office.

In contrast, if the FBO's current financial condition or market perception raises concerns regarding funds management and liquidity, the examiner should conduct a more in-depth evaluation of branch liquidity. The evaluation should consider the branch's funds management profile with close attention to: (1) funding sources; (2) liquidity and funding gaps; (3) funds management policy guidance from the head office; (4) current economic and market conditions; and (5) the adequacy of the contingency funding plan. The examiner should be prepared to make recommendations to address any identified or potential concerns at the branch and, if appropriate, at other U.S. or U.S.-managed or controlled offshore operations.

FBOs with multiple U.S. operations may centralize funds management and liquidity at a regional U.S. office. The examination of such a regional U.S. office, therefore, should include an evaluation of funds management and liquidity

1. This information is available to examiners as a part of the FBO's annual strength of support assessment. Examiners should review this assessment as a part of the pre-examination planning process, and be prepared to consider this information in evaluating the branch's funds management and liquidity.

for the branch's entire area of responsibility, including any U.S.-managed or controlled off-shore operations.

FUNDS MANAGEMENT AND LIQUIDITY PROFILE

The examiner should understand and evaluate the branch's funding and liquidity profile. Regardless of the condition of the FBO, the branch's funding profile, or whether the branch manages its own funding needs, this review should begin with an understanding of the FBO's funds management guidelines and practices for the branch. Head office should provide branch management with funds management and liquidity guidelines and some method of daily monitoring compliance with these guidelines. Generally, the greater the complexity of the branch or its responsibilities in funds management and liquidity, the more comprehensive the guidelines and monitoring practices.

A major point to consider in evaluating branch liquidity is whether the FBO views the branch as a net user or provider of funds. The examiner should determine if the FBO has been a consistent supplier of funds, or whether the branch acts as a dollar funding vehicle for the FBO. This determination, which is particularly important if the FBO raises liquidity concerns, will be evident from the trend in the net "Due From" position with related parties. The examiner should review a period of branch quarterly Reports of Assets and Liabilities (FFIEC 002) to determine the direction, volume, and frequency of the flow of funds between the branch and its head office or other related parties, including U.S.-managed or controlled offshore operations. The examiner should take into consideration that an analysis of quarter-end reports may not provide a true picture of ongoing activities due to certain types of balance sheet window dressing activities employed by the branch. Average statements of condition should be obtained in order to get a true picture of branch liquidity over time. From a supervisory viewpoint, a net due to position is regarded more favorably than a net due from position because it provides a cushion for nonrelated depositors and creditors. However, any recommendations related to the branch's funding role should be considered in relation to the FBO's overall financial condition and other factors discussed in this section. For

additional information on funding transactions with related parties, refer to Section 3240, Due From/Due To Related Parties.

The evaluation of funds management and liquidity should also consider the branch's cost and distribution of funds; economic and market trends; levels of liquid assets; future earnings capacity; asset quality; concentrations; customer mix; the nature and mix of its assets and liabilities, including maturity, currency and repricing mismatches; and its anticipated funding needs. Generally, these considerations are more significant if the branch manages its own funding and liquidity needs.

The remaining discussion is applicable to branches that are not simply net users of funds and have some degree of control over their funds management.

POLICY GUIDANCE

Branch management is expected to maintain policies and procedures approved by head office that facilitate the development of funding and liquidity strategies. Policies and procedures should provide an outline of goals regarding the FBO's asset and liability management, liquidity, off-balance-sheet exposure, degree of risk tolerance, and other relevant factors. The individual or committee responsible for funds management decisions, including monitoring anticipated funding needs, funding strategies, guidelines and limitations, should be specified in the policies and procedures. The depth of these policies and procedures will depend upon the degree to which branch management is responsible for funds management. In some cases, the head office or U.S. regional management is largely responsible for funds management at the branch. In other cases, responsibility rests with local branch management.

Policy statements should address limitations on funding sources to avoid a concentration to any one source or grouping. They also should identify alternative funding sources, the degree of support dictated by the FBO, and the nature of that support. Interest rate sensitivity matching, maturity matching, and the use of financial derivatives may be addressed under these policies or in a separate interest rate risk policy. Written procedures should provide staff with a reference document on the day-to-day proce-

dures in funding and provide for a system of internal control in critical areas, such as separation of duties, proper completion of reports, and monitoring of limits. Refer to Interest Rate Risk Management, Section 3210 for additional information on policies and procedures.

MANAGEMENT INFORMATION SYSTEMS

An effective Management Information System (MIS) is integral to making sound funds management and liquidity decisions and is a factor in evaluating the branch's financial controls. Reports containing certain basic information should be prepared and reviewed regularly by management. Report content and format will vary among branches; however, an effective MIS will contain reports detailing liquidity needs and the sources of funds available to meet those needs. Typically MIS may include the following: the maturity distribution of assets and liabilities, and the related gaps, including maximum and minimum liquidity needs; expected funding of commitments; asset yields; liability costs; net interest margins and variances (both from prior months and budget); funding volumes by liability, customer, market, and overnight/short-term funds; and exceptions to policy guidelines and limits. Refer to Section 3410, Management Information Systems, for additional information.

FUNDING AND LIQUIDITY PRACTICES

A branch responsible for its own funding and liquidity needs may meet those needs by manipulating its asset structure through the sale or planned runoff of short-term or readily marketable assets. As an alternative, the branch could transfer to the head office or other related offices, a block of assets that would serve to reduce its asset base and increase liquidity. As a matter of general practice, however, a branch can meet its liquidity needs by manipulating its liability structure to access discretionary funding sources or derive funds from its intercompany funding base. The ability of a branch to access discretionary funding sources is ultimately a function of the position and reputation of the FBO in the money markets. An FBO with

a good reputation affords its branches easier access to funds at market rates.

The ability to obtain additional funding sources represents liquidity potential. The marginal cost of liquidity or the cost of incremental funds acquired is of paramount importance in evaluating liability sources of liquidity. Consideration must be given to factors such as how frequently the branch must regularly refinance maturing liabilities and an evaluation of the branch's ongoing ability to obtain funds under normal market conditions. The obvious difficulty in estimating the latter is that until the branch goes to the market to borrow, it cannot determine with complete certainty that funds will be available at a price that will maintain a positive yield spread. Changes in money market conditions or the FBO's reputation and/or financial strength may cause a rapid deterioration in a branch's capacity to borrow at a favorable rate. In this context, liquidity potential represents the ability to attract funds in the market, when needed, at reasonable cost compared to asset yield.

Frequently, the base rate for funding costs on money market transactions is available only to the largest and most financially sound institutions. Some branches may pay in excess of the base rate for money market funds, with the differential denoting the market's perception of the FBO and home country conditions. The size of the premium compared to other FBOs can be a rough indication of the stability of funding sources in this market. As indicated earlier, if the FBO carries a rating of AAA or AA by an independent rating agency, it is unlikely that funding and liquidity will be an examination issue. If the FBO carries a lower rating or has no market presence, the probability that there may be funding and liquidity concerns grows proportionately and funds management and liquidity are more critical.

FUNDING AVAILABILITY

Management at the branch and head office must be constantly aware of the composition, characteristics, and diversification of its funding sources. If possible, the branch should secure funding lines from multiple sources. In certain instances, the branch may be using suballocated lines from its head office. With multiple source advised discretionary lines of credit, the branch

is much better positioned to manage usage and rotation in order to ensure availability of funds at competitive pricing. The role of the FBO in this circumstance would be to provide backup resources and to be the ultimate lender for contingency purposes.

Nevertheless, many interbank credit agreements contain escape provisions, known as material adverse change clauses, that enable the lending bank to refuse to allow the borrowing bank to draw on advised credit lines. Banking organizations experiencing considerable problems, particularly those relating to asset quality and/or liquidity, have found that these facilities are no longer available. Such escape provisions should be considered in the assessment of funds management and liquidity.

CONTINGENCY FUNDING

Examiners should determine if management at the branch has an effective contingency plan that identifies minimum and maximum liquidity needs both in normal and adverse market conditions, and weighs alternative courses of action to meet these needs. The branch may rely on back-up funding lines or support from the head office or other related offices to meet unforeseen liquidity demands. In this case, examiners should comment on the FBO's ability to meet these needs.

HOME COUNTRY FUNDING RESTRICTIONS

An FBO's home country may impose restrictions on capital outflows. Such impediments

could defeat the attempts of the FBO to aid the branch in the event of a liquidity crisis. For this reason, the examiner should investigate home country funding restrictions.

TRANSFER RISK CONSIDERATIONS

The stability and availability of funding should be related to the distribution of assets, taking into consideration certain assets subject to transfer risk. Potential liquidity problems may exist when a branch relies heavily on the U.S. money market for funding, while its assets are concentrated in a country with serious economic problems. In such a case, the branch is typically in a net due from position with the FBO and problems may arise if the FBO or borrowers do not have ready access to U.S. dollars to meet their obligations. Refer to Section 6020, Transfer Risk, for additional information.

OFF-BALANCE-SHEET CONSIDERATIONS

The nature, volume and anticipated usage of off-balance-sheet activity must be factored into the assessment of funds management and liquidity. The potential for funding contingent liabilities varies widely, but the most likely to require funding are loan commitments. Economic conditions and the business cycle may also influence anticipated usage. The branch should have sufficient existing funding sources to provide for anticipated usage, in view of the nature and volume of its contingent liabilities.

Funds Management and Liquidity

Examination Objectives

Effective date July 1997

Section 3200.2

1. To assess the branch's ability to obtain stable funding sources from related and unrelated parties.
2. To determine if reasonable local policies, procedures, and parameters have been established and approved by the head office for the branch's liquidity position and if the branch is operating within those established guidelines.
3. To evaluate the management of assets, liabilities, and off-balance-sheet positions to determine if management is planning adequately for liquidity and if the branch can effectively meet anticipated and potential liquidity needs.
4. To determine if internal management reports provide the necessary information for informed liquidity decisions and monitoring their results, and that reports are regularly provided and reviewed by head office.
5. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Funds Management and Liquidity Examination Procedures

Effective date July 1997

Section 3200.3

1. Evaluate the funding relationship between the branch and the FBO. Consider the reasons why the branch is in a net due from or due to position with related offices and affiliates of the FBO.
2. Review the Funds Management and Liquidity policies, practices, and procedures and test for compliance. Ensure that there are:
 - a. Lines of authority and responsibility for liquidity management decisions.
 - b. Formal mechanisms to coordinate funds management and liability decisions.
 - c. Methods to identify liquidity needs and the means to meet those needs.
 - d. Guidelines for the level of liquid assets and funding sources in relation to anticipated and potential needs.
 - e. Appropriate controls and supervision of the volume of loan commitments and other off-balance sheet exposure that may impact funding and liquidity.
3. Determine if management has planned properly for liquidity and if the branch has adequate sources of funds to meet anticipated or potential needs by:
 - a. Reviewing the internal management reports detailing liquidity requirements and sources of liquidity.
 - b. Evaluating primary and secondary sources of funds.
 - c. Determining whether funding and liquidity requirements are factored into the budgeting process and are based on growth projections, changes in the branch's asset and liability mix, and other anticipated changes.
4. Evaluate the effectiveness of the internal management reporting system in providing for adequate liquidity management.
5. Discuss the following issues with management and summarize findings in the workpapers and, to the degree necessary, for the examination report:
 - a. The quality of the branch's planning and the current ability of the branch to meet anticipated and potential liquidity needs.
 - b. The quality of administrative control and internal management reporting systems.
6. Update the workpapers with any information that will facilitate future examinations. Discuss with senior branch management the findings of the examination regarding the branch's funding and liquidity policies and practices, and document the discussion in the workpapers.

Funds Management and Liquidity Internal Control Questionnaire

Effective date July 1997

Section 3200.4

1. Is the FBO in less than satisfactory condition and subject to liquidity concerns?
2. Is the FBO subject to market disciplinary pricing?
3. Does the FBO's home country impose restrictions on capital outflows?
4. Has the branch and head office management, consistent with its duties and responsibilities, adopted funds management policies, practices and procedures which include:
 - a. Lines of authority, and responsibility for funds management and liquidity decisions?
 - b. A formal mechanism to coordinate funds management and liquidity decisions?
 - c. A method to identify funding and liquidity needs and the means to meet those needs?
 - d. A contingency funding plan that provides guidelines for the level of liquid assets and other sources of funds in relationship to anticipated and potential needs?
 - e. An adequate system of internal controls in critical areas, such as separation of duties, proper MIS reporting and monitoring of limits?
 - f. Transfer risk considerations?
5. Does the FBO view the branch as net user or provider of funds?

If the branch is a net user of funds:

 - a. Does the branch have a funding and liquidity profile that identifies the branch as a non-risk taker?
 - b. Are funds management and liquidity decisions centralized at an FBO location within the U.S. that is subject to regulatory supervision?

If the branch is a net provider of funds, answer the following questions; otherwise proceed to question 12.
6. Have internal management reports been prepared that provide an adequate basis for making ongoing liquidity management decisions and for monitoring the results of those decisions?
7. Do management reports include the following:
 - a. Maturity distribution of assets and liabilities?
 - b. Expected funding commitments?
 - c. Asset yields and liability costs?
 - d. Net interest margin and variance analysis (e.g., previous month, quarter, year-to-date and budget reporting)?
 - e. Funding volumes by type of liability (e.g., overnight/short-term funds), customer and market?
 - f. Exceptions to policy guidelines and limits?
8. Does the planning and budgeting function consider funding and liquidity requirements?
9. Does the branch's contingency funding plan address:
 - a. Minimum and maximum liquidity needs and alternative courses of action to meet those needs?
 - b. Alternative sources of funding?
 - c. Orderly asset liquidation?
10. Have adequate discretionary (back-up) lines of credit been established?
11. Are advised discretionary lines of credit containing adverse change clauses considered by branch management in its contingency funding plan?
12. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
13. Based on the information gathered, evaluate the internal controls in this area (i.e., strong, satisfactory, fair, marginal, unsatisfactory).

Interest rate risk (IRR) is an aspect of normal banking operations that became increasingly important in the United States with the deregulation of interest rates in the early 1980s. The phaseout of interest rate controls and increased competitiveness, the latter of which was partly due to the growing presence of foreign banks in U.S. markets, significantly increased the flexibility of banks in adjusting their IRR profiles. This flexibility has been further enhanced by the development of new financial instruments used to hedge against or profit from interest rate changes.

In order to maintain profitability, safety, and soundness, institutions should fully comprehend the risks associated with changes in interest rates and should have adequate policies and systems in place for controlling these risks. In this regard, the branch and its head office management both have important responsibilities.

The head office is responsible for providing clear policy guidance to branch management on controlling and monitoring IRR. The policies provided to branch management by the head office should indicate acceptable levels of risk-taking, given the branch's role in the foreign banking organization (FBO), and establish procedures and controls to ensure that there is an adequate system for measuring IRR and monitoring compliance with established limits. In this regard, there should also be a reporting process that demonstrates adherence with established limits and an adequate system of internal controls.

It is recognized that, as part of a larger entity, IRR management for certain branches may be centralized within the FBO. Whether or not the branch is responsible for managing its IRR, there should be evidence at the branch, in the form of IRR policy guidelines, management reports, etc., showing how this risk is being effectively identified, measured, and controlled for the branch. *The following discussion provides an overview of IRR considerations, which the examiner should use in reviewing, to the extent applicable, this area of risk within the branch.*

INTEREST RATE RISK

IRR is defined as a branch's vulnerability to changes in interest rates. IRR arises from differ-

ences in the maturities or repricing dates of asset and liability positions, and cash flows. However, risk may remain in a given branch's portfolio in which long and short positions of different maturities are well hedged against a uniform change in all interest rates, but not against a change in the shape of the yield curve where interest rates of different maturities change by varying amounts. This type of risk is called "yield-curve risk." Similarly, a branch may be well hedged against yield curve risk but exposed to "basis risk," in which the prices of particular assets and liabilities, as well as hedging instruments, are not perfectly correlated. For example, three-month interbank deposits priced at LIBOR, three-month Eurodollars and three-month Treasury bills all pay three-month interest rates. However, these three-month rates are not perfectly correlated with each other and spreads between their yields may vary over time. As a result, three-month Treasury bills, for example, funded by three-month interbank deposits are not a perfectly hedged position. Given a rise or decline in interest rates, a branch's interest rate exposure can be viewed as the potential for change in its reported earnings.

Focusing on the sensitivity of a branch's reported earnings to changes in interest rates represents an accounting perspective of IRR assessment. In general, this approach involves assessing the effect that changing rates might have on the revenues produced by interest-earning assets, the expense of interest-bearing liabilities, and the resulting net interest income of the branch. Risk to current earnings measures the timing of income effects, which can help risk managers determine what action to take regarding exposure.

RISK MEASUREMENT TECHNIQUES

Branches can use a variety of methods to measure their IRR exposure. The three most common generic methods are maturity gap analysis (used to measure the interest rate sensitivity of earnings), duration analysis, and simulation modeling. While these methods highlight different facets of IRR, many branches use them in combination or use hybrid methods that combine features of each.

Maturity Gap Analysis

Maturity gap analysis begins with constructing a maturity gap report. This report categorizes asset and liability accounts, including off-balance-sheet items, according to the time remaining to their maturities in specific time periods, known as repricing buckets. These buckets vary from branch to branch, but most branches include time bands of overnight, overnight to one month, one month to three months, three months to six months, six months to one year, and beyond one year. Categorizing assets and liabilities lacking definitive repricing time frames into specific time periods (or buckets) varies by institution. As a result, the assumptions used by each institution should be reviewed by the examiner to ensure that they are reasonable. This approach reflects the accounting or current earnings orientation of gap reports.

For each time period or bucket, rate-sensitive liabilities (RSL) are subtracted from rate-sensitive assets (RSA) to yield the dollar maturity mismatch or gap. The gap measure is either a positive or negative dollar amount and is the primary tool used to assess the impact of changes in interest rates on the institution's net interest income.

A negative gap (liability sensitive) indicates that more liabilities than assets will reprice in a given time period. During periods of rising interest rates, net interest income would be adversely affected because the interest expense on liabilities during that period would show a greater increase relative to the increase in interest earnings on assets. If rates decline, a bank with a negative gap would expect its earnings to be enhanced because more liabilities than assets would reprice at lower rates.

Conversely, a positive gap (asset sensitive) indicates that more assets than liabilities will reprice in a given time period. In this case, earnings tend to increase as interest rates increase because more assets than liabilities reprice at higher rates.

The maturity gap of an institution is the most basic measure of IRR. It is a static measure that assumes the current balance sheet remains constant through time and a given change in interest rates is not reversed over time. For this reason, it may not accurately reflect a branch's true risk exposure. In addition, its emphasis on the risk to short-term earnings inadequately addresses the rate sensitivity of longer-term fixed rate instru-

ments, the value of which can change dramatically without affecting short-term interest income.

Some simple forms of maturity gap analysis identify only the amount of assets and liabilities at risk and ignore basis risk. Basis risk refers to the likelihood that changes in interest rates a branch pays on liabilities and earns on its assets are not perfectly correlated. That risk is present, even when the assets and liabilities are matched in terms of their maturity or repricing periods. Despite these shortcomings, most branches use maturity gap analysis or some variant, as one component of IRR measurement. Many branches elaborate on the simple gap framework in order to gain insight into the more complex aspects of IRR.

While the maturity gap of an institution is a widely used indicator of IRR, it is not a sufficient measure for gauging overall exposure when taken alone. A branch's condition and size, complexity of the balance-sheet and off-balance-sheet activities (if any), degree of competition, and sophistication of the markets being served also must be considered. For example, a small, retail-oriented branch may have moderately large negative gap positions but may not be exposed to major risks. Factors that may minimize such risks are the branch's strong core deposit base within its target market.

Duration Analysis

Duration analysis is used to calculate the weighted average maturity of the cash flows emanating from financial instruments. In contrast to the simple average nominal cash flows, duration provides more meaningful, analytical measures of a stream of cash flows. The duration measure can be used to calculate the percentage change in the present value of a stream of cash flows that is generated by a one percentage point change in interest rates. Duration analysis can measure the exposure of a branch's current income to changes in interest rates.

Duration analysis can complement gap analysis. Using gap repricing data and selected rate data, duration provides a more accurate measure of IRR. Duration analysis, unlike gap analysis, accounts for the time value of money by calculating the present value of future cash flows. In so doing, it properly aggregates the branch's repricing mismatches or gaps. Thus, duration can be used to analyze the risk standing of a

branch with a complicated series of repricing mismatches. Like gap analysis, duration analysis generally assumes that the repricing structure of a branch's assets and liabilities remains constant. In addition, duration analysis requires information on cash flows that may not always be available.

Used in conjunction with maturity gap analysis, duration analysis can add significant insights into the IRR exposure of an institution. However, duration also has some limitations, in particular:

- The duration measure becomes less accurate as the amount of the interest rate change increases;
- The duration of different instruments will change at different rates as time passes, resulting in a hedged position becoming unhedged over time; and,
- Duration alone does not address the dispersion of cash flows in a branch's portfolio.

Simulation Modeling

Simulation techniques attempt to overcome the limitations of both the static gap and duration measures by computer-modeling the branch's interest rate sensitivity. Such modeling involves making assumptions about the future course of interest rates and changes in a branch's business activity and estimating their effect on the branch's net interest income. Branches can develop their own simulation packages or choose from a variety of commercially available packages.

A simulation model can provide branch management with an important tool for understanding the measurement of, and assisting in the management of, IRR, and for evaluating the branch's exposure under a variety of interest rate scenarios. Simulation techniques can also play an integral planning role in evaluating the effect of alternative business strategies on risk exposure. Unlike other methods, simulation can anticipate the effect of changes in customer behavior induced by interest rate changes (such as time deposit rollovers, in retail branches).

The usefulness of simulation techniques depends on the validity of the underlying assumptions and the accuracy of the basic structure upon which the model is run. If these assumptions do not fairly reflect the branch's

internal and external environment, the results obtained will not be meaningful.

ASSESSMENT OF IRR MANAGEMENT

Examiners should focus on the presence of clear and comprehensive policies with corresponding appropriate internal controls when assessing the management of IRR. The policies should outline the following: the objectives of risk management, clear lines of authority and communication, and limits on the vulnerability of net interest income to changes in interest rates. Risk management systems and procedures should be adequate and consistent with the stated policies of risk management.

Strong internal management controls need to be maintained given the potential impact of interest rate exposure on a branch's earnings. These controls include policies, risk measurement systems, and reporting mechanisms. Each of these should be reviewed from two perspectives:

- Does management understand and effectively administer IRR controls?
- Do these controls establish reasonable parameters considering the specific IRR profile of the branch?

In larger branches, IRR may be managed by an Asset/Liability Management Committee (ALCO), which is composed of senior branch managers who represent units that undertake IRR. ALCO is responsible for formulating and administering branch strategy with regard to IRR, which is based on management's view of the future interest rate environment, the branch's relative ability to adjust to changing market conditions, and the head office's risk-acceptance level. The activities of ALCO, including the implementation of IRR policies, should be reviewed for approval by the head office.

Additionally, in the cases where IRR management is centralized at a particular branch of the FBO, the following question must be considered: Is the process of transferring a given branch's IRR to the portfolio of the branch housing the centralized IRR management function adequately governed by appropriate policies and accurate reporting mechanisms?

POLICIES

The need for established and properly supervised IRR policies has increased greatly in recent years. An adequate policy facilitates the development of a prospective plan that considers the branch's goals regarding its asset and liability mix, off-balance-sheet activities, liquidity, risk tolerance, and other relevant factors. The policy should establish responsibility for IRR management decisions and provide a mechanism for the necessary coordination among different departments of the branch, or between different branches of the FBO, as appropriate.

In addition to establishing responsibility for planning and day-to-day IRR decisions, the policy should set forth certain guidelines:

- Interest rate exposure limits should be established relative to reasonable forecasts and assumptions;
- Limits should be based on the potential impact of interest rate changes on the branch's net interest income;
- Individual limits should be set for units that incur IRR;
- Clear lines of authority and communication should be established for the implementation and execution of strategies; and,
- For those branches that are not authorized to incur or manage IRR, the policy should clearly outline procedures for accurately and effectively transferring the IRR incurred by its normal business activities to a designated branch or other office of the FBO responsible for the centralized management of IRR.

In most cases branches accomplish the transfer of IRR incurred by a given transaction by entering into an offsetting, "mirror" transaction with the office responsible for managing the branch's IRR. As an example, if a branch entered into a five-year, fixed-rate loan, it could book a five-year, fixed-rate liability to the related office to fund the loan; the maturity and principal amount should be matched.

RISK MANAGEMENT SYSTEMS

The effectiveness of assessing IRR through the use of a risk management system depends to a large degree on the branch's ability to measure its exposure. Risk management systems are based on a quantitative assessment of exposure

(as previously discussed) and management's adaptation and analysis of that assessment. These systems should be:

- Consistent with established limits;
- Comprehensive, covering the rate risk associated with all asset, liability, and off-balance sheet accounts;
- Capable of identifying excessive exposure;
- Capable of measuring the impact of rate changes on the branch's chosen target account(s);
- Flexible, so that the introduction of new instruments and changes in strategy can be absorbed and accounted for; and,
- Able to suggest strategies for corrective action.

REPORTING MECHANISMS

Strong lines of communication and authority are essential to the timely execution and adjustment of a branch's IRR strategy because earnings can be rapidly eroded by unexpected rate changes. In particular, when risk management responsibilities are delegated to those most familiar with particular products or markets, the need for communication becomes stronger, so that positions in one market are not excessively magnified by positions elsewhere.

Coordination between the branch and head office management and business units that incur IRR is essential to the successful control of IRR. This is especially important when the business unit incurring IRR is another branch of the FBO. Controls should focus on the following:

- Branch and head office management should be regularly apprised of the nature and results of risk management decisions undertaken by the branch;
- Branch and head office management should be provided with periodic status reports detailing risk exposure;
- Treasury management should have periodic contact with branch line managers responsible for undertaking risk;
- Risk-taking units should be aware of limits established by head office and/or branch management, with limit exceptions regularly monitored and communicated to senior management; and,
- Units not allocated risk limits should provide the branch responsible for its IRR manage-

ment with reports detailing not only the unit's current positions, but potential or planned transactions, as well.

PRICING

Conclusions drawn from the analysis of the branch's interest rate sensitivity position rest upon the assumption that the branch has an adequate asset-pricing mechanism. A pricing mechanism that is not attuned to the branch's cost of funds, overhead costs, and credit risk will not allow the branch to maintain an adequate net interest margin on an ongoing basis. Thus, the examiner should bear in mind the interdependence of pricing methods and interest rate sensitivity when assessing the branch's ability to maximize and maintain the spread between interest earned and interest paid.

An important component of pricing is the cost of funds. Bankers generally price from either the average cost of funds or the marginal cost of funds. The average cost of funds is a weighted average of all of the rates paid on interest-bearing liabilities. The marginal cost of funds is defined as the cost of the additional funds needed to support asset growth and is considered by many bankers to be the more economically appropriate method. This view is taken because funds on the balance sheet already support assets held and the cost of those funds should not enter into the pricing decision for new assets.

The marginal cost of funds is not, however, always the best method of pricing because the branch may be replacing assets, instead of growing. If the branch is only changing its asset mix to compensate the organization for its credit risk, its average cost of funds, plus overhead and repricing considerations, represent a more appropriate pricing measure. Additionally, market forces, which include the demand for and availability of funds, should be considered as complements to cost factors when making pricing decisions. The market in which the branch operates often dictates the pricing mechanism used.

Branches most often obtain funds from the domestic interbank money market; however, offshore sources, including related branches and the head office, are frequently used. In many

cases, a FBO may have to pay an additional spread over interbank rates for perceived country risk, liquidity risk, or credit risk. For branches required to pay such additional spreads, the size and volatility of these premiums should be considered in the institution's pricing mechanism.

HEDGING

The examiner should keep in mind that risk may be reduced by hedging activities when determining the extent of IRR exposure at the branch. These activities may be explicit and easily quantifiable or they may be implicit and difficult to measure from the branch's management information system.

Types of explicit hedging activities include instruments such as futures, interest rate swaps, forwards, options, and various hybrid products. Types of implicit hedging might include interest rate caps and floors on commercial loans; limits on the amount of rate adjustment allowed for products, such as adjustable rate mortgages; or even investment policies that might set internal stop loss limits on various longer-term portfolio positions. Explicit hedging strategies can either be matched to a specific asset or liability ("micro" hedges) or be designed to reduce the overall level of risk in a position ("macro" or "portfolio" hedging).

Institutions engaged in hedging activities should have clearly defined policies that outline specific hedge strategies and explain how those strategies reduce risk. Individuals responsible for hedging activity should be designated and overall position limits should be established. Internal controls should be established to include a system that measures the degree to which a hedge is meeting its stated objective of reducing risk (hedge effectiveness). Finally, branch management should regularly provide reports to the head office that, at a minimum, show gains or losses on hedge instruments and estimates of hedge effectiveness.

Finally, some entities now use derivative instruments in managing IRR. The individual regulatory agencies have issued policy statements regarding derivative instruments. The examiner should consult with his/her respective agency for guidance.

Interest Rate Risk Management

Examination Objectives

Effective date July 1997

Section 3210.2

1. To evaluate the policies regarding interest rate risk (IRR) formulated by branch and head office management, including the limits established for the branch's IRR profile.
2. To determine if the branch's IRR profile is within those limits.
3. To evaluate the management of the branch's IRR, including the adequacy of the methods and assumptions used to measure IRR.
4. To determine if internal management reporting systems provide the information necessary for informed interest rate management decisions.
5. To recommend corrective action when interest rate management policies, practices, procedures, or internal controls are deficient in controlling and monitoring IRR.

Interest Rate Risk Management Examination Procedures

Effective date July 1997

Section 3210.3

1. Determine if there were concerns in the previous examination report regarding IRR, and if corrective action was required.
2. Determine if IRR is managed at the branch level or at another level within the FBO.
 - a. If IRR is managed at the branch level, proceed to procedure #3.
 - b. If IRR is managed at a higher level within the FBO:
 - Determine if adequate procedures are in place for any activities at the branch which are required by the managing level within the FBO (i.e. personnel authorized and steps necessary for calling in funding requirements).
 - Provide a description of the activities conducted by the managing level within the FBO.
 - Proceed to procedure #10.
3. Review the branch's written policies and procedures for reasonableness. At a minimum, policies should cover:
 - a. Definition and measurement of acceptable risks, including acceptable levels of interest rate exposure.
 - b. Net interest margin goals.
 - c. Sources and uses of funds.
 - d. Off-balance-sheet activities that affect interest rate exposure.
 - e. Responsibilities within the branch for IRR management activities.
 - f. Reporting mechanisms.
4. Evaluate the internal controls and/or the internal audit function. Determine whether internal mechanisms are adequate to ensure compliance with established limits on IRR. Prepare a brief description of the branch's internal controls/audit for IRR management and identify areas in need of improvement.
5. Evaluate management practices. The evaluation should include, but not be limited to, the following:
 - a. Determine who is responsible for making IRR management decisions (individual, committee or other), and whether this is appropriate, given the level of experience and sophistication of the individuals and the nature of the branch's activities.
 - b. Determine who is responsible for making principal assumptions and parameters used in the measurement system(s), and whether this individual or committee reviews the principal assumptions and parameters on a regular basis and updates them as needed.
 - c. Determine who is responsible for implementing strategic decisions. Ensure that the scope of that individual's authority is reasonable. Determine if any one individual exerts undue influence over the economic forecasts and management decisions.
 - d. Assess branch management's knowledge of IRR in relation to the size and complexity of the branch. In particular, assess management's understanding of the methods used by the branch to measure the risk.
 - e. Determine if new products or hedging instruments are adequately analyzed before purchase.
6. Assess senior management (i.e. lead U.S. office for FBO or head office) oversight of IRR management. The assessment should include the following:
 - a. Determine how frequently the policy is reviewed and approved by senior management (at least annually).
 - b. Determine whether the results of the measurement system provide clear and reliable information and whether the results are communicated to senior management at least quarterly. Reports to senior management should identify the branch's current position and relationship to policy limits.
 - c. Determine the extent to which exceptions to policies and resulting corrective measures are reported to senior management, including the promptness of such reporting.
7. Evaluate the risk measurement system(s) used by the branch, which should be consistent with the size and complexity of its on- and off-balance-sheet activities. The evaluation should include the following:
 - a. Evaluate whether the risk measurement system's structure and capabilities are adequate to accurately assess the risk exposure of the branch, support the institution's risk management process,

- and serve as a basis for internal limits and authorizations.
- b. Evaluate whether the risk measurement system is operated with sufficient discipline to accurately assess the risk exposure of the branch, support the institution's risk management process, and serve as a basis for internal limits and authorizations.
 - c. Determine whether the assumptions are reasonable given current business conditions and the institution's strategic plan, and whether assumptions about future business are sensitive to changes in interest rates.
8. Evaluate the branch's exposure to IRR by:
 - a. Reviewing reports regularly prepared by management for controlling and monitoring IRR.
 - b. Reviewing "variance reports," i.e., reports that compare predicted and actual results. Comment on whether the risk measurement system has made reasonably accurate predictions in earlier periods.
 - c. Determining whether the level of risk is within the limits management has set.
 - d. Determining the stability of interest margins under varying economic conditions or simulations (causes of significant fluctuations should be identified).
 - e. Determining the branch's ability to adjust its interest rate exposure, or its ability to effectively transfer its interest rate exposure to the designated unit of the FBO for IRR management.
 9. Contact the examiner responsible for analyzing income and expense to determine the adequacy of the net interest margin, based on an analysis of the components of the margin (i.e., interest expense and interest income). If the margin or any component is unusually high or low, determine:
 - a. If goals have been established for net interest earnings.
 - b. Management's success in meeting established goals.
 - c. The effect of the branch's IRR position on meeting established goals.
 - d. The effect of the branch's pricing policies on meeting established goals.
 - e. The effect of any premium charged the branch on borrowed funds resulting from any perceived liquidity risk, country risk, or credit risk on meeting established goals.
 - f. The effect of the branch's credit risk appetite on the margin.
 - g. The effect of interoffice pricing policies for borrowed funds from related offices, and the reliance on these funds, on the margin.
 10. Write in appropriate report format and discuss with management:
 - a. The quality of management's ability to control and monitor IRR.
 - b. The level of the branch's IRR exposure and an assessment of the associated degree of risk.
 - c. The quality of the related administrative controls and internal management reporting systems.
 - d. The effect of IRR management decisions on earnings.
 11. Update the workpapers with any information that will facilitate future examinations.

Interest Rate Risk Management Internal Control Questionnaire

Effective date July 1997

Section 3210.4

Complete the following questions only if IRR is managed at the local level. If IRR is managed at another level within the FBO, determine that adequate procedures are in place for any activity required of the branch by the managing office.

1. Has branch and head office management adopted an IRR management policy that includes:
 - a. Risk management philosophy and objectives regarding IRR?
 - b. Clear lines of responsibility to either manage IRR or transfer the branch's IRR positions to the appropriate unit of the FBO assigned the IRR management function?
 - c. Defining and setting of limits on IRR exposure?
 - d. Specific procedures for reporting and approvals necessary for exceptions to policies and limits?
 - e. Plans or procedures management will implement if IRR falls outside established limits?
 - f. Specific IRR measurement system(s)?
 - g. Acceptable activities used to manage or adjust the institution's IRR exposure, including, when applicable, procedures for the transfer of IRR to the unit assigned the IRR management function?
 - h. The individuals or committees who are responsible for IRR management decisions?
 - i. A process for evaluating major new products and their IRR characteristics?
2. Have internal management reports been prepared that provide an adequate basis for making interest rate management decisions and for monitoring the results of those decisions? Specifically:
 - a. Are reports prepared on the branch's IRR exposure, using an appropriate measurement method?
 - b. Is historical information on asset yields, cost of funds, and net interest margins readily available?
 - c. Are interest margin variations, both from the prior reporting period and from the budget, regularly monitored?
 - d. Is sufficient information available to permit an analysis of the cause of interest margin variations?
3. Is the bank in compliance with its policies, and is it adhering to its written procedures? If not, are exceptions and deviations:
 - a. Approved by appropriate authorities?
 - b. Made infrequently?
 - c. Nonetheless consistent with safe and sound banking practices?
4. Does senior management review and approve the policy at least annually?
5. Did senior management review positions, and the relationship of these positions to established limits, at least quarterly?
6. Were exceptions to policies promptly reported to the senior management?
7. Does one individual exert undue influence over interest risk management activities?
8. Discuss with senior management the branch's internal risk measurement model(s) regard to the following:
 - a. Has (Have) internal model(s) been audited (by internal or external auditors)?
 - b. Does one individual control the modeling process, or otherwise exert undue influence over the risk measurement process?
 - c. Is the model reconciled to source data to assure data integrity?
 - d. Are principal assumptions and parameters used in the model reviewed periodically by senior management?
 - e. Are the workings of, and the assumptions used in, the internal model adequately documented and available for examiner review?
 - f. Is the model run on the same scenario(s) for which the institution's limits are established?
 - g. Does management compare the historical results of the model to actual results?

CONCLUSION

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

Borrowed funds include all nondeposit liabilities, exclusive of long-term subordinated debt, such as capital notes and debentures. Common forms of direct borrowing include Federal funds purchased (overnight and term), bills payable to the Federal Reserve, interbank deposits (domestic or foreign), due bills, short sales from trading securities, and overdrafts on deposit accounts due from other depository institutions. Indirect forms of borrowing include rediscounted customer paper, trade bills and bankers acceptances, securities borrowed, and assets sold with the endorsement or guarantee of the FBO or subject to a repurchase agreement. If an FBO issues commercial paper in the U.S., the issuance is generally through a U.S. subsidiary and reflected on the books of the branch as a balance due to related institutions.

When a branch manages its borrowed funds position independently from other FBO offices, a complete analysis of its borrowing activities since the previous examination should be done. The principal sources of borrowings, the range of amounts, frequency, length of time indebted, concentration of borrowings, and reasons advanced by management for such borrowings should be explored. Some of the more frequently used sources and instruments that provide short-term, nondeposit funds are discussed below.

INTRACOMPANY/INTERCOMPANY BORROWING

A principal borrowing relationship frequently exists between a branch and its head office. The branch may also have borrowing relationships with other related branches or affiliated companies. The head office frequently serves as a primary funding source for the branch, but the level and nature of borrowing may be determined by other factors, including the branch's role in the overall funding strategy of the FBO. For example, an FBO will designate one U.S. branch (generally the branch located in the FBO's home state) to provide the funding to all other U.S. branches. To develop a complete understanding of the borrowing relationship of the branch with the head office and other related offices, the examiner must gain an understanding of the funding strategy of the FBO in the

U.S., and should determine the purpose of the borrowing and the reason for the level and flow of funds to various offices.

For FBOs with a controlling interest in a U.S. commercial bank, a borrowing relationship between the commercial bank and offices of the FBO must be explored fully to ensure there are no violations of Sections 23A and 23B of the Federal Reserve Act, inasmuch as the FBO is considered a foreign bank holding company. Additional information on intercompany borrowing and funding relationships is contained in Section 3240, Due From/Due To Related Offices.

FEDERAL FUNDS PURCHASED

The day-to-day use of Federal funds is commonplace among U.S. banking organizations, including branches of FBOs. The most frequent type of Federal funds transaction is unsecured, for one day, and repayable the following business day. The rate is usually determined by overall money market rates and by the available supply of and the demand for funds. Most transactions are in units of \$1 million, although the trading of smaller amounts is fairly common depending upon individual situations. In some instances, where the selling and buying relationship between two financial institutions is a more or less continuing one, a line of credit may be established on a funds-available basis. Although the most common transaction is on an "overnight" unsecured basis, the selling of funds can also be on a secured basis and for longer periods of time such as term Federal funds. While term Federal funds are quite common, the selling of funds on a secured basis is quite rare. Secured borrowing is usually done in instances of severe credit risk and/or perceived default. However, according to the Federal Reserve Act, Section 23A(c)(1), if an FBO owns a domestic, FDIC-insured subsidiary bank, any extensions of credit by the domestic bank to the FBO must be done on a secured basis.

INTERBANK DEPOSITS AND BORROWINGS

Interbank deposits are not defined as borrowings for regulatory purposes, and continue to be

reflected as deposits. Interbank deposit instruments include certificates of deposits (CDs), Eurodollar deposits or takings (Euro-CDs) and deposits taken under separate borrowing agreements. These funds are generally obtained through the branch's money market deposit taking activities. However, narrowly defining these instruments as deposits instead of borrowings is not universally accepted and, in fact, the negotiable money market CD and Euro-CD are widely recognized as primary borrowing vehicles. Dependence on CDs and Euro-CDs as sources of funds is discussed in Section 3230, Deposit Accounts.

Negotiable CDs and Euro-CDs are generally used by wholesale branches. They consist of deposits over \$100,000 and are not considered core funds. The major distinction between Euro-CDs and negotiable CDs is that Euro-CDs are primarily funds from offshore sources. With more diverse products entering the market, floating rate CDs and floating rate Euro-CDs are becoming more popular.

REPURCHASE AGREEMENTS

Instead of resorting to direct borrowing, a branch may sell assets to another bank or some other party and simultaneously agree to repurchase the assets at a specified time or after certain conditions have been met. Securities and loans are often sold under repurchase agreements to generate temporary working funds. Agreements of this nature are frequently used because the cost of this type of secured borrowing is generally lower than that of unsecured borrowings, such as Federal funds purchased. Repurchase agreements should not be confused with resale agreements (also known as reverse repurchase agreements). The usual terms for sale of securities under a repurchase agreement require that, after a stated period of time, the seller repurchases the same securities at a predetermined price or yield. U.S. government and agency securities are the most common type of instruments sold under repurchase agreements because they are exempt from reserve requirements.

Management should be aware of certain considerations and potential settlement risks associated with repurchase agreements entered into in large volume with institutional investors and/or brokers. If the value of the underlying securities exceeds the price at which the repur-

chase agreement was sold, the branch could be exposed to the risk of loss in the event that the buyer is unable to perform and return the securities. This possibility is more likely if the securities are physically transferred to the institution or broker with which the branch has entered into the repurchase agreement. For this reason, branches should avoid, if possible, pledging excessive collateral. However, most transactions today do not involve the physical transfer of securities, rather they involve a book entry system which can reduce settlement risk. The branch should obtain sufficient financial information on and analyze the financial condition of those institutions and brokers with whom they engage in repurchase transactions.

Branches engaging in repurchase agreements should include these transactions when calculating their interest rate sensitivity positions. In addition, the degree to which a branch borrows through repurchase agreements should be analyzed with respect to its liquidity needs, and contingency plans should provide for alternate sources of funds in the event of a run-off of repurchase agreement liabilities.

LINES OF CREDIT FROM CORRESPONDENT BANKS

Lines of credit with correspondent banks may be on an advised or unadvised basis. Advised (also known as committed or fee paid) lines of credit provide a reliable source of back-up funding to the branch, in that the correspondent bank is committed to lend under the specified terms of the credit facility. Unadvised lines of credit are not committed facilities and access to such funds can be denied by the correspondent bank. On occasion, branches negotiate loans from their principal correspondent banks. The loans are usually for short periods and may or may not be secured. Lines of credit to finance trade transactions evidenced by letters of credit can result in the correspondent bank financing the branch for an additional period of time, after a sight draft drawn under a letter of credit has been presented at the correspondent bank.

SHORT-TERM DEBT

Short-term borrowings may be found in a branch, both on a direct and indirect basis. Borrowings

on a direct basis are usually evidenced by promissory notes, or through accounts with the head office or a correspondent bank. Indirect forms of borrowing include notes and trade bills rediscounted; notes, acceptances, import drafts, or trade bills sold with the branch's endorsement or guarantee; notes and other obligations sold subject to repurchase agreements; and acceptance pool participations.

common form of long-term debt is direct term borrowings from correspondent banks. Branches are usually more interested in attracting long-term funds through the U.S. capital markets for their head office than issuing long-term debt for their own utilization.

LONG-TERM DEBT

On an infrequent basis, long-term debt borrowings may be found in a branch. The most

Borrowed Funds

Examination Objectives

Effective date July 1997

Section 3220.2

1. To determine if the policies, practices, procedures, and internal controls regarding borrowed funds are adequate.
2. To determine if branch officers are operating in conformity with the established guidelines of the head office.
3. To determine the scope and adequacy of the internal/external audit function as it relates to borrowed funds.
4. To determine compliance with laws and regulations as it relates to borrowed funds.
5. To determine if the existing level of borrowed funds is consistent with the branch's activities.
6. To determine if the existing rates paid are in line with concurrent market rates.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Borrowed Funds

Examination Procedures

Effective date July 1997

Section 3220.3

1. If selected for implementation, complete or update the Internal Control Questionnaire.
2. Determine if deficiencies noted at the previous examination or by internal/external audits have been addressed by management.
3. Determine the purpose of each type of borrowing and whether the branch's borrowing posture is justified in light of its role within the FBO's network and other relevant circumstances.
4. Determine if the branch has adequate contingency plans for alternate sources of funds and if these contingency funding lines are periodically tested for availability.
5. Prepare, in appropriate report form, and discuss with appropriate management:
 - a. The adequacy of written policies regarding borrowings.
 - b. The manner in which branch officers are operating in conformance with established policy.
 - c. The existence of any unjustified borrowing practices.
 - d. Any violation of laws or regulations.
 - e. Recommended corrective action when policies, practices, or procedures are deficient; violations of laws or regulations exist; or when unjustified borrowing practices are being pursued.
6. Update the workpapers with any information that will facilitate future examinations.

POLICY

1. Has the head office approved a written policy which:
 - a. Outlines the objectives of the branch's borrowings?
 - b. Describes the branch's borrowing philosophy relative to risk considerations, i.e., leverage/growth, liquidity/income?
 - c. Provides for risk diversification in terms of staggered maturities, rather than solely on cost?
 - d. Limits borrowings by amount outstanding, specific type, or total interest expense?
 - e. Limits or restricts execution of borrowings by branch officers?
 - f. Provides a system of reporting requirements to monitor borrowing activity?
 - g. Requires subsequent approval of transactions?
 - h. Provides for review and revision of established policy at least annually?
- a. Handle cash?
- b. Issue official checks and drafts?
- c. Prepare all supporting documents required for payment of debt?
4. Are subsidiary records for borrowed funds reconciled with the general ledger accounts at an interval consistent with borrowing activity, and are the reconciling items investigated by persons who do not also:
 - a. Handle cash?
 - b. Prepare or post to the subsidiary records for borrowed funds?
5. Has it been determined that borrowings from U.S. bank subsidiaries conform with applicable regulatory restrictions?
6. Are corporate resolutions properly prepared as required by creditors and are copies on file for reviewing personnel?
7. Are monthly reports furnished to the head office management reflecting the activity of borrowed funds, including amounts outstanding, interest rates, interest paid to date, and anticipated future activity?

RECORDS

2. Does the branch maintain subsidiary records for each type of borrowing, including proper identification of the obligee and a written confirmation?
3. Is the preparation, addition, and posting of the subsidiary borrowed funds records performed or adequately reviewed by persons who do not also:

CONCLUSION

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

Borrowed Funds

Audit Guidelines

Effective date July 1997

Section 3220.5

1. Using an appropriate sampling technique, select items for review of supporting documentation, including terms, balances, and other appropriate details, and request a positive confirmation from the lender. Control all answered confirmations and investigate any reported differences. Include all confirmations in the workpapers and document the disposition of all exceptions or no-replies.
2. To the extent appropriate, review collateralized transactions for the sufficiency of security to cover the lender's requirements and ensure that the branch's assets pledged as collateral are clearly identified.
3. Examine supporting documents for accuracy and trace applicable entries, including proceeds, to detail records and to the general ledger.
4. Test interest computations for accuracy and trace entries to appropriate accounts.
5. Examine transactions for adherence with terms of borrowing arrangements.
6. Review all borrowings requiring head office approval for appropriate documentation and authorization.

U.S. branches of foreign banking organizations (FBOs) may hold deposits, which represent funds that branch customers have advanced and the branch is obligated to repay on demand, after a specific period of time, or after expiration of some required notice period. Definitions of deposit types (i.e., demand, savings, and NOW accounts and their respective availabilities) are outlined in the Federal Reserve Board's Regulation D and in the instructions to the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002). The nature, type, and level of deposits that a branch may accept is dependent on a variety of factors, including the licensing agency, applicable state restrictions, Federal Deposit Insurance Corporation insurance status, and the limitations imposed based on the type of office, i.e., depository or nondepository office. Management should have policies in place to ensure compliance with all applicable deposit-taking restrictions.

The majority of U.S. branches of FBOs do not maintain FDIC insurance and are therefore subject to relevant notification requirements described in the Federal Deposit Insurance-Insured and Uninsured Branches section of this manual. These wholesale branches generally may accept deposits over \$100,000 or from U.S. nonresidents. Branches, however, can accept deposits of less than \$100,000 from residents provided the branch's total retail deposits do not exceed 1 of its total deposits. Refer to FDIC Rules and Regulations Part 346 for additional information. Licensing agencies may apply additional deposit-taking restrictions, which should be incorporated into the review's scope. Uninsured branches (non-FDIC-insured) may face legal limitations on deposits but generally have greater flexibility in taking borrowed funds. Examiners should review the documentation supporting deposit and borrowed funds transactions to determine that they are properly identified and reported.

Guidelines applicable to offices with FDIC-insured deposits are also available in the section on Federal Deposit Insurance- Insured and Uninsured Branches.

Some branches use private banking departments to gather and retain large deposit bases. For more information on these departments, see the Private Banking section in this manual.

REGULATION K SUBPART B SECTION 211.21(B)—CREDIT BALANCES

As defined in Regulation K, Subpart B, Section 211.21(b), Credit Balances, U.S. agencies, as opposed to branches, of FBOs are *not* allowed to accept deposits from U.S. citizens or residents. Agencies may, however, maintain credit balances for U.S. citizens and residents, in addition to taking deposits from foreign residents. Obligations are not considered credit balances unless they meet *all* of the following conditions:

- Arise out of, or are incidental to the exercise of other lawful banking powers, such as the disbursement of loan proceeds, receipt of wire transfer activities, or arise out of letter of credit transactions;
- Serve a specific purpose;
- Are not solicited from the general public;
- Are not used to pay routine operating expenses in the United States, such as salaries, rent, or taxes;
- Are withdrawn, within a reasonable period of time, after the specific purpose for which they were placed has been accomplished; and
- Are drawn upon in a manner reasonable in relation to the size and nature of the account.

The agency's Report of Assets and Liabilities should correctly show such credit balances.

The remaining discussion applies to those branches that rely heavily on retail deposits as a funding source.

DEPOSIT DEVELOPMENT AND RETENTION PROGRAM

Branch management should adopt and implement a development and retention program for all types of deposits because of competition for funds, the need for most individuals and corporations to minimize idle funds, and the effect of disintermediation (the movement of deposits to other higher-yielding markets) on a branch's deposit base. The review of a branch's deposit development and retention program and the methods used to determine the volatility and composition of the deposit structure are important elements of the examination process. The

deposit development and retention program is often included in the funds management policy and should contain a marketing strategy, projections of deposit structure and associated costs, and a formula for comparing results against projections.

Marketing Strategy

In determining its market strategy, management must first consider many factors, including:

- The composition of the market area economic base, especially the countries targeted by the private banking, corporate banking, or correspondent banking departments;
- The ability to employ deposits profitably;
- The adequacy of current operations (staffing and systems) and the location and size of banking quarters relative to its volume of business;
- The degree of competition from banks and nonbank financial institutions and their programs to attract deposit customers; and
- The effects of the local and foreign economies and the monetary and fiscal policies of the local and foreign government on the branch's market area.

After a deposit program is developed, management must continue to monitor those factors and correlate any findings to determine if adjustments are needed. The long term success of any deposit program relates directly to the ability of management to detect the need for change at the earliest possible time.

Deposit Structure and Associated Costs

Management should not only look at deposit growth but also at the characteristics of the deposit structure. Management must be able to determine what percentage of the overall deposit structure is centered in stable or core deposits, in fluctuating or seasonal deposits, and in volatile deposits to properly invest such funds in view of anticipated or potential withdrawals.

It is important that internal reports with information concerning the composition of the deposit structure be provided periodically to both branch and head office management. In analyzing the deposit structure, information gathered by the

various examination procedures should be sufficient to allow the examiner to evaluate the composition of both volatile and core deposits. Management's lack of such knowledge could lead to an asset/liability mismatch, which could cause problems at a later date. Ultimately, the examiner should be satisfied that management has properly planned for the branch's future.

Examiners must analyze the present and potential effect deposit accounts have on the financial profile of the branch, particularly with regard to the quality and scope of management's planning. The examiner's efforts should be directed to the various types of deposit accounts that the branch uses for its funding base. The examiners assigned to funds management and to analytical review of the branch's income and expenses should be informed of any significant change in interest-bearing deposit account activity.

For branches with a significant deposit base, interest paid on deposits can represent the largest expense to the branch. Additional costs associated with deposits include general operating costs, promotional and advertising costs, and changes in required reserves. As a result, interest-bearing deposit accounts employed in a marginally profitable manner could have significant and lasting effects on branch earnings. Refer to the Income and Expense Section of this manual for additional information.

Comparing Results to Projections

Management should have a formula in place for comparing results against projections. Projections should be periodically reviewed and updated throughout the fiscal year. Actual results should be periodically compared to projections and material variances should be identified and reviewed by management. Typically, the branch's annual budget will include projections for deposits and associated costs. Refer to the Income and Expense section of this manual for additional information on comparing actual results to those projected.

SPECIAL DEPOSIT-RELATED ISSUES

The examiner should keep in mind the following issues during an examination to ensure that the branch is in compliance, where applicable.

Abandoned Property Law

State abandoned property laws are generally called escheat laws. Although escheat laws vary from state to state, they normally require a branch to remit the proceeds of any deposit account to the state treasurer when:

- The deposit account has been dormant for a certain number of years; and
- The owner of the account cannot be located.

Service charges on dormant accounts should bear a direct relationship to the cost of servicing the accounts to ensure that the charges are not excessive. Management should have policies and procedures in place to review and document the basis on which service charges on dormant accounts are assessed. There have been occasions when, because of excessive charges, there were no proceeds to remit at the time the account became subject to escheat requirements and courts have required banks to reimburse the state. (Refer to the discussion on dormant accounts in the subsequent Potential Problem Areas section.)

Bank Secrecy Act

Examiners should be aware of the Bank Secrecy Act when examining the deposit area and follow up on any unusual activities or arrangements noted. The Act was implemented by the Treasury Department's Financial Recordkeeping and Reporting of Currency and Foreign Transactions Regulation. For further information, see the Federal Reserve's Bank Secrecy Act Manual, Section 208.14 of the Federal Reserve's Regulation H, and other supervisory material. The Federal Reserve's Bank Secrecy Act Manual also includes information on "Know Your Customer" guidelines.

Banking Hours and Processing of Demand Deposits

The Uniform Commercial Code (UCC) allows a bank or branch to establish a banking day cut-off hour of 2:00 p.m. or later for the handling of items received for deposit or presented for payment (UCC 4-108). A banking day is defined as the part of a day on which the bank or branch is open to the public for substantially all of its

banking functions (UCC 4-104(a)(3)). For branches with retail deposit-taking activities, a banking day generally includes, at a minimum, operation of a teller window and the bookkeeping and loan departments. Items received on a nonbanking day or after the cut-off hour on a banking day may be processed as if received on the following banking day.

A branch that violates the cut-off hour could be subject to civil liability for not performing its duties under other provisions of the UCC (see UCC 4-202, 4-213, 4-214, 4-301, and 4-302).

Foreign Currency Deposits

Branches are permitted to accept deposits denominated in foreign currency. Branches should notify customers that such deposits are subject to foreign exchange risk. The branch converts such accounts to the U.S. dollar equivalents for reporting to the Federal Reserve. Examiners should verify that all reports are in order and evaluate the branch's use of such funds and management of the accompanying foreign exchange risk. Foreign currency denominated accounts are not subject to the requirements of Regulation CC, Availability of Funds and Collection of Checks. For additional information, examiners may refer to the Federal Reserve's supervisory guidance letter, SR-90-3 (IB), Foreign (Non-U.S.) Currency Denominated Deposits Offered at Domestic Depository Institutions.

International Banking Facilities

An International Banking Facility (IBF) is a set of asset and liability accounts segregated on the books of a branch. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. When examining an IBF, the examiner should follow the special examination procedures in the International Banking Facility section of this manual.

Reserve Requirements

Under the Monetary Control Act of 1980 and the Federal Reserve's Regulation D, Reserve

Requirements of Depository Institutions, branches are subject to reserve requirements in the following instances:

- It is an insured branch, and its parent foreign bank has total worldwide consolidated bank assets in excess of \$1 billion; or
- It is an insured branch, and is controlled by a foreign company or by a group of foreign companies that own or control foreign banks that in the aggregate have total worldwide consolidated bank assets in excess of \$1 billion; or
- It is a branch that is eligible to apply to become an insured bank under section 5 of the Federal Deposit Insurance Act.

For reserve requirement purposes, there are two categories of deposits: transaction accounts and nontransaction accounts. Refer to the Federal Reserve's Regulation D and the FFIEC 002 instructions for specific definitions of the various types of deposits. Branches may choose to maintain reserves for discount window access.

POTENTIAL PROBLEM AREAS

The following paragraphs discuss the types of deposit accounts and related activities that have above-average risk and, therefore, require the examiner's special attention.

Branch-Controlled Deposit Accounts

Branch-controlled deposit accounts, such as suspense, official checks, cash collateral, dealer reserves, and undisbursed loan proceeds are used to perform many necessary banking functions. However, the absence of sound administrative policies and adequate internal controls regarding these accounts can cause significant loss to the branch. To ensure that such accounts are properly administered and controlled, branch and head office management must ensure that operating policies and procedures are in effect that establish acceptable purpose and use; appropriate entries; controls over posting entries; and the length of time an item may remain unrecorded, unposted, or outstanding. Internal controls that limit employee access to branch-controlled accounts, determine the responsibility for frequency of reconciliation, discourage

improper posting of items, and provide for periodic internal supervisory review of account activity are essential to efficient deposit administration.

The deposit suspense account is used to process unidentified, unposted, or rejected items. Characteristically, items posted to such accounts clear in one business day. The length of time an item remains in control accounts often reflects on the branch's operational efficiency. This deposit type has a higher risk potential because the transactions are incomplete and require manual processing to be completed. Due to the need for human interaction and the exception nature of these transactions, the possibility of misappropriation exists.

Official checks are a type of demand deposit, and include bank checks, cashier's checks, expense checks, interest checks, dividend payment checks, certified checks, and money orders. Official checks reflect the branch's promise to pay a specified sum upon presentation of such checks. Because accounts are controlled and reconciled by branch personnel, it is important that appropriate internal controls are in place to ensure that account reconciliation is segregated from check origination. Operational inefficiencies, such as unrecorded checks that have been issued, can result in a significant understatement of the branch's liabilities. Misuse of official checks may result in substantial losses through theft.

Cash collateral, undisbursed loan proceeds, and various loan escrow accounts are also sources of potential loss. The risk lies in inefficiency or misuse if the accounts become overdrawn or if funds are diverted for other purposes, such as the payment of principal or interest on branch loans. Funds deposited to these accounts should be used only for their stated purposes.

Brokered Deposits

Brokered deposits represent funds the branch obtains, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts. Thus, brokered deposits include both those in which the entire beneficial interest in a given branch deposit account or instrument is held by a single depositor and those in which the deposit broker pools funds from more than one investor for deposit in a given branch deposit account.

A small or medium-sized branch's dependence on the deposits of customers who reside outside of or conduct their business outside of the branch's normal service area should be closely monitored by branch and head office management, and analyzed by the examiner. Such deposits may be the product of personal relationships or good customer service; however, large out-of-area deposits are sometimes attracted by liberal credit accommodations or by offering significantly higher interest rates than competitors offer. Deposit growth due to liberal credit accommodations generally proves costly in terms of the credit risks taken relative to the benefits received from corresponding deposits, which may be less stable. Deposit development and retention policies should recognize the limits imposed by prudent competition and the branch's service area.

Banking organizations have historically relied to a limited extent upon funds obtained through deposit brokers to supplement their traditional funding sources. A concern regarding the activities of deposit brokers is that the ready availability of large amounts of funds through the issuance of such obligations undercuts market discipline, particularly in insured depository institutions. To compensate for the high rates typically offered for brokered deposits, institutions holding them tend to seek assets that carry commensurately high yields. These assets can often involve excessive credit risk or cause the branch to take on undue interest-rate risk through a mismatch in the maturity of assets and liabilities.

In light of these concerns, certain restrictions on the use of brokered deposits were developed under section 301 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which apply to federally-insured branches. Section 301 of FDICIA amended section 29 of FDIA to prohibit undercapitalized institutions from accepting funds obtained, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts. Adequately capitalized institutions may accept such funds only if they first obtain a waiver from the FDIC, while well-capitalized institutions may accept such funds without restriction. Refer to FDIC regulations and guidelines for information on how these requirements are applied to federally-insured branches. Each examination should include a review for compliance with the FDIC's limitations on the

acceptance of brokered deposits and guidelines on interest payments.

The use of brokered deposits should be reviewed during all on-site examinations, even for those institutions not subject to the FDIC's restrictions. In light of the potential risks accompanying the use of brokered deposits, the examination should focus on:

- The rate of growth and the credit quality of the loans or investments funded by brokered deposits;
- Whether brokered funds are in turn sold to branch customers;
- The corresponding quality of loan files, documentation, and customer credit and deposit information;
- The ability of branch management to adequately evaluate and administer these credits and deposits and manage the resulting growth;
- The degree of interest-rate risk involved in the funding activities and the existence of a possible mismatch in the maturity or rate-sensitivity of assets and liabilities;
- The composition and stability of the deposit sources and the role of brokered deposits in the branch's overall funding position and strategy; and
- The effect of brokered deposits on the branch's risk standing and whether or not the use of brokered deposits constitutes an unsafe and unsound banking practice.

Check Kiting

Check kiting occurs when a depositor with accounts at two or more banks draws checks against the uncollected balance at one bank to take advantage of the float (i.e., the time required for the bank of deposit to collect from the paying bank); and the depositor initiates the transaction with the knowledge that sufficient collected funds will not be available to support the amount of the checks drawn on all of the accounts.

The key to this deceptive practice, the most prevalent type of check fraud, is the ability to draw against uncollected funds. However, drawing against uncollected funds in and of itself does not necessarily indicate kiting. Kiting only occurs when the aggregate amount of drawings exceeds the sum of the collected balances in all accounts. Nevertheless, because drawing against

uncollected funds is the initial step in the kiting process, management should closely monitor this activity. The requirements of Regulation CC, Availability of Funds and Collection of Checks, increased the risk of check kiting and should be addressed by management in the branch's policies and procedures.

By allowing a borrower to draw against uncollected funds, the branch is extending credit that should be subject to an appropriate approval process. Accordingly, management should promptly investigate unusual or unauthorized activity because the last bank to recognize check kiting and pay on the uncollected funds suffers the loss. Check kiting is illegal, and all suspected or known check kiting operations should be reported pursuant to established regulatory policy. Branch management should maintain internal controls to preclude loss from kiting and the examiner should remember that, in most cases, kiting is not covered under Blanket Bond Standard Form 24.

Delayed Disbursement Practices

Although Regulation CC, Availability of Funds and Collection of Checks, stipulates time frames for funds availability and return of items, delayed disbursement practices (also known as remote disbursement practices) can present certain risks, especially concerning cashier's checks, which have next-day availability. Delayed disbursement is a common cash management practice that consists of arrangements designed to delay the collection and final settlement of checks by drawing checks on institutions located substantial distances from the payee or on institutions located outside the Federal Reserve cities when alternate and more efficient payment arrangements are available. Such practices deny depositors the availability of funds to the extent that funds could otherwise have been available earlier. A check drawn on an institution remote from the payee often results in increased possibilities of check fraud and in higher processing and transportation costs for return items.

Delayed disbursement arrangements could give rise to supervisory concerns because a branch may unknowingly incur significant credit risk through such arrangements. The remote location of institutions offering delayed disbursement arrangements often increases the collection time for checks by at least a day or more.

The primary risk is payment against uncollected funds, which could be a method of extending unsecured credit to a depositor. Absent proper and complete documentation regarding the creditworthiness of the depositor, paying items against uncollected funds could be considered an unsafe or unsound banking practice. Furthermore, such loans, even if properly documented, might exceed the branch's prudential lending limit, if applicable, for loans to one customer.

Examiners should routinely review a branch's practices in this area to ensure that such practices are conducted prudently. If undue or undocumented credit risk is disclosed or if lending limits are exceeded, appropriate corrective action should be taken.

Deposit Sweep Programs/Master Note Arrangements

Deposit sweep programs/master note arrangements (sweep programs) can be implemented on a branch level or on a FBO level. On a branch level, these sweep programs exist primarily to facilitate cash management needs of branch customers, thereby retaining customers who might otherwise move their account to an entity offering higher yields. On a FBO level, the sweep programs are maintained with customers at the branch level and the funds are upstreamed to the FBO as part of its overall funding strategy. Sweep programs use an agreement with the branch's deposit customers (typically corporate accounts) that permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight investments. These obligations include such instruments as commercial paper, program notes, and master note agreements.

For insured branches, the disclosure agreement regarding the sale of these types of non-deposit debt obligations should include a statement indicating that these instruments are not federally insured deposits or obligations of or guaranteed by an insured depository institution. In addition, insured branches and their related parties and subsidiaries that have issued or plan to issue nondeposit debt obligations should not market or sell these instruments in any public area of the branch where retail deposits are accepted, including any lobby area of the branch. This requirement exists to convey the impression or understanding that the purchase of such

obligations by retail depositors of the federally-insured branch can, in the event of default, result in losses to individuals who believed they had acquired federally-insured or guaranteed obligations.

Branch Policies and Procedures

Banking organizations with sweep programs should have adequate policies, procedures, and internal controls in place to ensure that the activity is conducted in a manner consistent with safe and sound banking principles and in accordance with all banking laws and regulations. Branch policies and procedures should further ensure that deposit customers participating in a sweep program are given proper disclosures and information. When a sweep program is used as part of a funding strategy for a FBO or a nonbank affiliate, examiners should ensure that liquidity and funding strategies are carried out in a prudent manner.

Application of Deposit Proceeds

In view of the extremely short-term maturity of most sweep accounts, branches are expected to exercise great care when investing the proceeds. Branches, from which deposit funds are swept, have a fiduciary responsibility to their customers to ensure that such transactions are conducted properly. Appropriate uses of the proceeds of deposit sweep funds are limited to short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.¹ Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity prob-

1. Some banking organizations have interpreted language in a 1987 letter signed by the Secretary of the Board as condoning funding practices that may not be consistent with the principles set forth in a subsequent supervisory letter dated September 21, 1990, as well as with prior Board rulings. The 1987 letter involved a limited set of facts and circumstances that pertained to a particular banking organization; it did not establish or revise Federal Reserve policies on the proper use of the proceeds of short-term funding sources. In any event, banking organizations should no longer rely on the 1987 letter to justify the manner in which they use the proceeds of sweep programs. Banking organizations employing sweep programs are expected to ensure that these programs conform with the policies contained in this manual section.

lems and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

Funding Strategies

A key principle underlying the Federal Reserve's supervision of banking organizations is that FBOs should operate in a way that promotes the soundness of their U.S. operations. FBOs are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their U.S. operations. Any funding strategy should maintain an adequate degree of U.S. dollar liquidity at the U.S. operation and the FBO, if appropriate. Branch management should avoid, to the extent possible, allowing sweep programs to serve as a source of funds for inappropriate uses at the FBO or at an affiliate. Concerns exist in this regard, because funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in the FBO's viability.

Funding Programs

In developing and carrying out funding programs, FBOs should give special attention to the use of overnight or extremely short-term liabilities because a loss of confidence in the issuing organization could lead to an immediate funding problem. Thus, FBOs relying on overnight or extremely short-term U.S. dollar funding sources, should maintain a sufficient level of superior-quality assets that can be immediately liquidated or converted to cash with minimal loss, at least equal to the amount of those U.S. dollar funding sources.

Dormant Accounts

A dormant account is one in which customer-originated activity has not occurred for a predetermined period of time. Because of this inactivity, dormant accounts are frequently the target of malfeasance and should be carefully controlled by a branch. Branch management should establish standards that specifically outline the

branch's policy for the effective control of dormant accounts, addressing:

- The types of deposit categories that could contain dormant accounts, including demand, savings, and official checks;
- The length of time without customer-originated activity that qualifies an account to be identified as dormant;
- The controls exercised over the accounts and their signature cards, that is, prohibiting release of funds by a single branch employee; and
- The follow-up by the branch when ordinary branch mailings, such as account statements and advertising flyers, are returned to the branch because of changed addresses or other reasons for failure to deliver.

Employee Deposit Accounts

Historically, examiners have discovered various irregularities and potential wrongdoing through reviews of employee deposit accounts. As a result, if employees are permitted to maintain accounts at the branch, branch policy should establish standards that segregate or specially encode employee accounts and encourage periodic internal supervisory review. In light of these concerns, examiners should review related branch procedures and practices, taking appropriate measures when warranted.

Overdrafts

The size, frequency, and duration of deposit account overdrafts are matters that should be governed by branch policy and controlled by adequate internal controls, practices, and procedures. Overdraft charges should be significant enough to discourage abuse. Overdraft authority should be approved in the same manner as lending authority and should never exceed the employee's lending authority. Systems for monitoring and reporting overdrafts should emphasize a secondary level of administrative control that is distinct from other lending functions so account officers, who may be less than objective, do not allow influential customers to exploit their overdraft privileges. An examiner should also be aware that Regulation O addresses the payment of overdrafts to executive officers of a federally-insured branch. It is the responsibility

of branch management, with oversight from head office, to review overdrafts as they would any other extension of credit. In most cases, overdrafts outstanding for more than 30 days, which lack mitigating circumstances, should be considered for charge-off.

Payable-Through Accounts

A payable-through account is an accommodation offered to a correspondent bank or other customer by a U.S. banking organization, whether they have a domestic or foreign charter, whereby drafts drawn against client subaccounts at the correspondent are paid upon presentation by the U.S. banking institution. The subaccount holders of the payable-through bank are generally non-U.S. residents or owners of businesses located outside of the United States. Usually, the contract between the U.S. banking organization and the payable-through bank purports to create a contractual relationship, solely between the two parties to the contract. Under the contract, the payable-through bank is responsible for screening subaccount holders and maintaining adequate records with respect to such holders. The examiner should be aware of the potential for money laundering through payable-through accounts and should refer to the Bank Secrecy Act Manual for examination procedures.

Zero-Balance Accounts

Zero-balance accounts (ZBAs) are demand deposit accounts, used by a branch's corporate customers, through which checks or drafts are received for either deposit or payment. The total amount received on any particular day is offset by a corresponding debit or credit to the account before the close of business, to maintain the balance at or near zero. ZBAs enable a corporate treasurer to effectively monitor cash receipts and disbursements. For example, as checks arrive for payment, they are charged to a ZBA, with the understanding that funds to cover the checks will be deposited before the end of the banking day. Several common methods used to cover checks include:

- *Wire Transfers*;
- *Depository Transfer Checks*—a bank-prepared payment instrument used to transfer money

from a corporate account in one bank to another bank;

- *Concentration Accounts*—a separate corporate demand deposit account at the same bank used to cover deficits or channel surplus funds relative to the ZBA; and
- *Extended Settlement*—a cash management arrangement that does not require the corporate customer to provide same-day funds for payment of its checks.

Because checks are covered before the close of business on the day they arrive, the branch's exposure is not reflected in the financial statement. The branch, however, assumes risk by paying against uncollected funds, thereby creating unsecured extensions of credit during the

day (referred to as a daylight overdraft between the account holder and the branch). If these checks are not covered, an overdraft occurs, which will be reflected on the branch's financial statement.

The absence of prudent safeguards and a lack of full knowledge of the creditworthiness of the depositor may expose the branch to large, unwarranted, and unnecessary risks. Moreover, the magnitude of unsecured credit risk may exceed prudent limits. Examiners should routinely review cash management policies and procedures to ensure that branches do not engage in unsafe and unsound banking practices, making appropriate comments in the report of examination, as necessary.

Deposit Accounts

Examination Objectives

Effective date July 1997

Section 3230.2

1. To determine if the policies, practices, procedures, and internal controls regarding deposit accounts are adequate.
2. To determine if branch officers and employees are operating in conformance with the branch's established guidelines.
3. To evaluate the deposit structure and determine its characteristics and volatility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Deposit Accounts Examination Procedures

Effective date July 1997

Section 3230.3

1. Determine if deficiencies noted at the previous examination or by internal/external audits have been adequately addressed by management.
2. Check applicable restrictions on the nature, type, and level of deposits that can be maintained by the branch.
3. If selected for implementation, complete the ICQ.
4. In conducting an examination, the examiner should use available branch copies of print-outs plus transactions journals, microfiche, or other visual media to minimize expense to the branch. However, if copies of these reports are not available, the examiner should determine and request the information necessary to complete the examination procedures and, if required, the internal control questionnaire. Obtain or prepare, as applicable, the reports indicated below, which are used for a variety of purposes, including the assessment of deposit volatility and liquidity, adequacy of internal controls, verification of information contained on required regulatory reports, and assessment of loss.
 - a. For demand deposits and other transaction accounts:
 - Trial balance
 - Overdrafts
 - Unposted items
 - Nonsufficient funds (NSF) report
 - Dormant accounts
 - Uncollected funds
 - Due to banks
 - Trust department funds
 - Significant activity
 - Suspected kiting report
 - Matured certificates of deposits without an automatic renewal feature
 - Large balance report
 - b. For official checks:
 - Trial balance(s)
 - c. For time deposits:
 - Trial balance(s)
 - Unposted items
 - Dormant Accounts
 - Trust department funds
 - Large balance report
 - Money market accounts
 - Negotiable certificates of deposits
 - d. For deposit sweep programs/master note arrangements:
 - Maturity reports
 - List individually by deposit type and amount
 - e. For brokered deposits:
 - List individually by deposit type, including amount and rate
 - f. For foreign currency deposits:
 - List of accounts and currency type
 - g. For employee deposit accounts:
 - List individually by deposit type, including amount and rate
 - Overdrafts
 - Monthly account activity, including dollar and transaction volume
5. If an agency, for credit balances:
 - a. Review the agency's policy to ensure compliance with Subpart B Section 211.21(b) of Regulation K dealing with credit balances.
 - b. Determine that controls are in place to monitor compliance with the regulation.
 - c. Select a sample of credit balances and review transaction activity to determine if such balances are being used in accordance with the regulation.
6. Review the reconciliations of all types of deposit accounts and verify the balances to department controls and the general ledger, then:
 - a. Determine if reconciliation items are legitimate and if they clear within a reasonable time frame.
 - b. Retain custody of all trial balances, only if necessary and practical.
7. Test documentation on the underlying transactions reported as borrowed funds to ensure that these do not better fit the definition of deposits. Refer to the Borrowed Funds section of this manual and appropriate sections of the Board's Regulation D for additional guidance. If determined to be deposits, include such transactions in the review of deposits.
8. Review the reconciliation process for branch controlled accounts, such as official checks and escrow deposits, by:
 - a. Determining if reconciling items are legitimate and if they clear within a reasonable time frame.

- b. Scanning activity in such accounts to determine the potential for improper diversion of funds for various uses, such as:
 - Political contributions
 - Loan payments (principal or interest)
 - Personal use
- c. Determine if checks are being processed before their related credits.
9. Review the branch's operating procedures and reconciliation process relative to suspense accounts and determine if:
 - a. The disposition of unidentified items is completed in a timely fashion.
 - b. Reports are generated to periodically inform management of the type, age, and amounts of items in such accounts.
 - c. Employees responsible for clearing suspense account times are not shifting the items between accounts.
10. Evaluate the effectiveness of the policies, procedures, and management's reporting methods regarding overdrafts and drawings against uncollected funds.
 - a. Concerning overdrafts, determine if:
 - Officer-approval limits have been established
 - A formal system of review and approval is in effect
 - b. Ascertain the existence of formal overdraft protection, and, if it exists:
 - Obtain a master list of all depositors with formal overdraft protection
 - Obtain a trial balance indicating advances outstanding and compare it with the master list to ensure compliance with approved limits
 - Cross-reference the trial balance or master list to examiner loan line sheets
 - Review credit files on significant formal agreements not cross-referenced above
 - c. Concerning drawings against uncollected funds, determine if:
 - The uncollected funds report reflects balances as being uncollected until they are actually received
 - Management is comparing reports of significant changes in balances and activity volume to uncollected funds reports
 - Management knows the reasons why a depositor is frequently drawing against uncollected funds
 - A reporting system to inform senior management of significant activity in this area has been instituted
- Appropriate employees clearly understand the mechanics of drawing against uncollected funds and the risks involved, especially in the area of potential check kiting operations
- d. Upon completing steps 10.a., 10.b., and 10.c., the examiner should:
 - Cross-reference overdraft and uncollected funds reports to examiner loan line sheets;
 - For those depositors not cross referenced in the preceding step, review the credit files of depositors with significant overdrafts, if available, or the credit files of depositors who frequently draw significant amounts against uncollected funds;
 - Request management to charge off overdrafts deemed to be uncollectible by examiners; and
 - Submit a list of the following items to the appropriate examiner:
 - Overdrafts considered loss, indicating borrower and amount.
 - Aggregate amounts overdrawn 30 days or more, for inclusion in past due statistics.
11. Review the branch's deposit development and retention policy, which is often included in the funds management policy.
 - a. Determine if the policy addresses deposit structure and related interest costs, including the percentages of time deposits and demand deposits of:
 - Individuals
 - Corporations
 - b. Determine if the policy requires periodic reports to management, comparing the accuracy of projections with results.
 - c. Assess the reasonableness of the policy and ensure that it is routinely reviewed by management.
12. If a deposit sweep program/master note arrangement exists, review for approval of related policies and procedures by head office management.
13. For branches with deposit sweep programs/master note arrangements (sweep programs), compare practices for adherence to approved policies and procedures, including a review of:
 - a. The purpose of the sweep program: is it strictly a customer accommodation trans-

- action or is it intended to fund certain assets at the foreign banking organization (FBO) level or at an affiliate? Review funding transactions in light of liquidity and funding needs of the FBO by referring to the manual section on Funds Management and Liquidity.
- b. The eligibility requirements used by the branch to determine the types of customers and accounts that may participate in a sweep program, including:
- A list of customers participating in sweep programs, with dollar amounts of deposit funds swept on the date of examination.
 - The name of the recipient(s) of swept funds and:
 - If an affiliate of the branch (i.e., FBO), a schedule of the instruments into which the funds were swept, including the effective maturity of these instruments.
 - If an unaffiliated third party, determine if the branch adequately evaluates the third party's financial condition at least annually. Verify if a fee is received by the branch for the transaction and, if so, that it is disclosed in customer documentation.
- c. Whether the proceeds of sweep programs are invested only in short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.
- d. Whether the branch has issued or plans to issue nondeposit debt obligations in any public area of the branch where retail deposits are accepted, including any lobby area of the branch.
- e. Completed sweep program documents to determine if:
- In the case of federally-insured branches, signed documents boldly disclose that the instrument into which deposit funds will be swept is not insured by the FDIC and is not an obligation of or guaranteed by the branch.
 - Proper authorization for the instrument exists between the customer and an authorized representative of the branch.
- Signed documents properly disclose the name of the obligor and type of instrument into which the depositor's funds will be swept. If funds are being swept into U.S. government securities held by the branch or FBO, verify that adequate confirmations are provided to customers in accordance with the Government Securities Act of 1986. (This Act requires that all transactions subject to a repurchase agreement be confirmed in writing at the end of the day of initiation and that the confirmation covers specific securities. If any other securities are substituted that result in a change of issuer, maturity date, par amount, or coupon rate, another confirmation must be issued at the end of the day during which the substitution occurred. Because the confirmation or safekeeping receipt must list specific securities, pooling of securities for any type of sweep program involving government securities is not permitted. Additionally, if funds are swept into other instruments, similar confirmation procedures should be applied.)
 - Conditions of the sweep program are stated clearly, including the dollar amount (minimum or maximum amounts and incremental amounts), time frame of sweep, time of day sweep transaction occurs, fees payable, transaction confirmation notice, pre-payment terms, and termination notice.
 - The length of any single transaction under sweep programs in effect has not exceeded 270 days and the amount is \$25,000 or more (as stipulated by SEC policy). Ongoing sweep program disclosures should occasionally be sent to the customer to ensure that the terms of the program are updated and the customer understands the terms.
- f. In the case of federally-insured branches, samples of advertisements (newspaper, radio and television spots, etc.) by the branch for sweep programs to determine if the advertisements:
- Boldly disclose that the instrument into which deposit funds are swept is not insured by the FDIC and is not an obligation of, or guaranteed by, the branch.

- Are not enclosed with insured deposit statements mailed to customers.
- g. Whether the sweep program has had a negative effect on branch liquidity or has the potential to undermine public confidence in the branch. Additionally:
- Review the branch's Federal funds and other borrowing activities to ascertain whether borrowings appear high. If so, compare the branch's borrowing activity with daily balances of aggregate sweep transactions on selected dates, to see if a correlation exists.
 - If sweep activity is significant, compare the rates being paid on swept deposits with the yields received on the invested funds and with the rates on other overnight funding instruments, such as fed funds, to determine if they are reasonable.
14. Forward the following to the examiner assigned to Funds Management and Liquidity:
- a. The amount of any deposit decline or deposit increase anticipated by management (the time period will be determined by the examiner performing liquidity and funds management).
 - b. A listing by name and amount of any depositor controlling a significant percentage of total deposits.
 - c. A maturity schedule of certificates of deposit, detailing maturities within the next 30, 60, 90, 180, and 360 days.
 - d. An assessment of the overall characteristics and volatility of the deposit structure.
15. Assess the volatility and the composition of the branch's deposit structure.
- a. Review the list of time certificates of deposit of \$100,000 or more and related management reports to determine:
 - The aggregate dollar volume of bearer CDs, if significant.
 - The aggregate dollar volume of accounts of depositors by country.
 - If the branch is paying competitive rates on CDs.
 - The aggregate dollar volume of money market CDs with interest rates higher than current publicly quoted rates within the industry, if significant.
 - The dollar amount of brokered CDs, if any.
- b. Select, at a minimum, the 10 largest accounts to determine if the retention of those accounts depends on:
 - Criticizable loan relationships.
 - Liberal service accommodations, such as permissive overdrafts and drawings against uncollected funds.
 - Interbank correspondent relationships.
 - Deposits obtained as a result of special promotions.
 - A recognizable trend with respect to:
 - Frequent significant balance fluctuations.
 - Seasonal fluctuations.
 - Nonseasonal increases or decreases in average balances.
- c. Elicit management's comments to determine, to the extent possible:
- The potential renewal of large CDs that mature within the next 12 months.
 - If a significant dollar volume of accounts is concentrated in customers engaged in a single business or industry.
16. Test for compliance with the applicable laws and regulations listed below by performing the following procedures:
- a. For federally-insured branches, Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks:
 - Review the overdraft listing to ensure that the branch has not paid an overdraft on any account of an executive officer, unless the payment is made according to:
 - A written, preauthorized, interest-bearing extension of a credit plan providing for a method of repayment or
 - A written, preauthorized transfer from another account of that executive officer.
- Payment of inadvertent overdrafts in an aggregate amount of \$1,000 or less is not prohibited, provided the account is not overdrawn more than five business days and the executive officer is charged the same fee charged other customers in similar circumstances. Overdrafts are extensions of credit and must be included when considering each insider's lending limits and other extensions of credit restrictions and the aggregate lending limit for all outstand-

- ing extensions of credit by the branch to all insiders and their related interests.
- b. 12 USC 1972(2), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks:
 - Review the overdraft listing to ensure that no preferential overdrafts exist from the branch under examination to the executive officers, directors, or principal shareholders of its correspondent bank.
 - c. Section 301 of the Federal Deposit Insurance Corporation Improvement Act of 1991. Refer to the section on Federal Deposit Insurance-Uninsured and Insured Branches of this manual for procedural guidance.
 - d. Regulation D (12 CFR 204), Reserve Requirements of Depository Institutions:
 - Review the accuracy of the deposit data used in the branch's reserve requirement calculation for the examination date. In cases where a branch issues nondeposit, uninsured obligations that are classified as deposits in the calculation of reserve requirements, examiners should determine if these items are properly categorized.
- e. Local escheat laws:
 - Determine if the branch is adhering to the local escheat laws with regard to all forms of dormant deposits, including official checks.
 17. If applicable, determine if the branch is appropriately monitoring and limiting the foreign exchange risk associated with foreign currency deposits.
 18. Discuss overall findings with branch management and prepare report comments on:
 - a. Policy deficiencies.
 - b. Noncompliance with policies.
 - c. Weaknesses in supervision and reporting.
 - d. Violations of laws and regulations.
 - e. Possible conflicts of interest.

OPENING DEPOSIT ACCOUNTS

1. Are the opening of new accounts and access to unused new account records and certificate of deposit (CD) forms handled by an employee who is not a teller or who cannot make internal entries to customer accounts or general ledger?
2. Does the branch have a written “Know Your Customer” policy?
 - a. Do new account applications require sufficient information to clearly identify the customer?
 - b. Are “starter” checks issued only after verification of data on new transaction account applications?
 - c. Are checkbooks and statements mailed only to the address of record? If not, is a satisfactory explanation and description obtained for any other mailing address (post office boxes, friend or relative, etc.)?
 - d. Are employees responsible for opening new accounts trained to screen depositors for signs of check kiting?
 - e. Will the branch open new accounts with incomplete documentation?
3. Are accounts referred to the branch by representative offices? If so, are the representatives employees of the foreign banking organization? Are accounts referred to the branch by other related offices or affiliates? If so, who refers them and why are they booked at the branch? Do these representatives receive “Know Your Customer” training?
4. Are new account applications and signature cards reviewed by an officer prior to opening the account?

CLOSING DEPOSIT ACCOUNTS

5. Are signature cards for closed accounts promptly pulled from the active account file and placed in a closed file? Are closed account lists circulated to the appropriate management?

**REGULATION K SUBPART B
SECTION 211.21(B)—CREDIT
BALANCES**

6. Does the agency have a written policy that addresses credit balances?
7. Does the agency refuse to accept deposits from residents of the United States?
8. Does the agency’s system for monitoring credit balances include a continuing review of checks drawn on the account to ensure that the checks are not being used to pay for routine operating expenses in the United States?
9. Do customer deposit files contain sufficient documentation that show the foreign nature of the deposit or foreign citizenship or residency of the customer?
10. Are private banking officers or other agency personnel who solicit or open deposit accounts knowledgeable of the regulation’s limitations on the agency’s deposit-taking powers?

DEPOSIT ACCOUNT RECORDS

11. Is the preparation of input and posting of subsidiary demand deposit records performed and/or adequately reviewed by persons who do not also:
 - a. Accept or generate transactions?
 - b. Issue official checks and/or handle funds transfer transactions?
 - c. Prepare or authorize internal entries (return items, reversals, and direct charges, such as loan payments)?
 - d. Prepare supporting documents required for disbursements from an account?
 - e. Perform maintenance on the accounts, such as change of address, stop payments, holds, etc.?
12. Does the branch perform reconciliations for each deposit account category by individuals not engaged in accepting or preparing transactions or in data entry to customers’ accounts?
13. Do periodic reports prepared for management provide an aging of adjustments and differences and detail the status of significant adjustments and differences?

14. Are in-process, suspense, interoffice and other accounts related to deposit accounts controlled or closely monitored by persons who do not have posting or reconciliation duties?
15. Are periodic reports prepared for management on open items in suspense, in-process, interoffice and other deposit accounts and do the reports include aging of items and the status of significant items?
16. Does the branch segregate the deposit account files of:
 - a. Employees and officers?
 - b. The business interests of, or controlled by, employees and officers?
17. Are posting and check filing separated from statement preparation?
18. Are statements mailed or delivered to all customers, as required by the branch's deposit account agreement and in a controlled environment that precludes any individual from receiving any statement not specifically authorized by the customer or branch policy?
- f. Require a written request from the customer and verification of the customer's signature before releasing an account from the controlled environment?
20. Are accounts for which contact cannot be reestablished and do not reflect recent activity removed from active files and clearly classified as dormant?
21. Before returning a dormant account to active status, are transactions reactivating the account verified, independent confirmations obtained directly from the customer, and approval obtained for an officer who cannot approve transactions on dormant accounts?

INACTIVE ACCOUNTS

22. Are demand accounts that have been inactive for one year and time accounts that have been inactive for three years classified as inactive? If not, state the time period.
23. Does the branch periodically review the inactive accounts to determine if they should be placed in a dormant status and are decisions to keep such accounts in active files documented?

DORMANT ACCOUNTS AND RETURNED MAIL

19. Does the branch have formal policies and procedures for the handling of dormant accounts and customers' transaction and interest statements that are returned by the post office as undeliverable? Does the policy:
 - a. Require statements to be periodically mailed on dormant accounts? If so, how often?
 - b. Prohibit the handling of such statements by (1) account officer and (2) other individuals with exclusive control of accounts?
 - c. Require positive action to follow up on obtaining new addresses?
 - d. Require that statements and signature cards for accounts that cannot be contacted (the mail is returned more than once or marked "deceased") be placed into a controlled environment?
 - e. Require the branch to change the address on future statements to the department of the branch (controlled environment) designated to receive returned mail?

HOLD MAIL

24. Does the branch have a formal policy and procedure for handling statements and documents that a customer requests not to be mailed but will be picked up at a location within the branch? Does the policy:
 - a. Require that statements will not be held by an individual (an account officer, branch manager, bookkeeper, etc.) who could establish exclusive control over entries to and delivery of statements for customer accounts?
 - b. Discourage such arrangements and grant them only after the customer provides a satisfactory reason for the arrangement?
 - c. Require the customer to sign a statement describing the purpose of the request and the proposed times for pick-up and designate the individuals authorized to pick up the statement?
 - d. Require maintenance of signature cards for individuals authorized to pick up statements and compare the authorized signatures to those who sign for statements held for pick-up?

- e. Prohibit the delivery of statements to officers and employees requiring special attention, unless it is part of the formal “hold mail” function?
25. Is a central record maintained in a control area that does not originate entries to customers’ accounts and identify each “hold mail” arrangement, the designated location for pick-up, and the scheduled pick-up times? Does the control area:
 - a. Maintain current signature cards of individuals authorized to pick up statements?
 - b. Obtain signed receipts showing the date of pick-up and compare the receipts to the signature cards?
 - c. Follow up on the status of statements not picked up as scheduled?
 26. Does management review activity in “hold mail” accounts that have not been picked up for extended periods of time (for example, one year) and, where there is no activity, place the accounts in a dormant status?
 - a. Is the computation of the uncollected funds position based on reasonable check collection criteria?
 - b. Can the reports or a separate account activity report reasonably be expected to detect potential kiting conditions?
 - c. If reports are not generated for time transaction accounts, is a system in place to control drawings against uncollected funds?
 35. Do authorized officers review the uncollected funds reports and approve drawings against uncollected funds within established limits?
 36. Are accounts that frequently appear on the uncollected funds and/or kite suspect reports reviewed, regardless of account balances? (For example, accounts with simultaneous large debits and credits can reflect low balances.)

OTHER MATTERS

OVERDRAFTS

27. Are officer overdraft authorization limits formally established?
28. Does the branch require an authorized officer to approve overdrafts?
29. Is an overdraft listing prepared daily for demand deposit and time transaction accounts?
30. For branches processing overdrafts that are not automatically approved (“pay none” system), is the insufficient funds report circulated among branch officers?
31. Are overdraft listings circulated among the officers?
32. Are the statements of accounts with large overdrafts reviewed for irregularities?
33. Is a record of large overdrafts included in the monthly report to head office management and does it include the overdraft origination date?

UNCOLLECTED FUNDS

34. Does the branch generate a daily report of drawings against uncollected funds for demand deposits and time transaction accounts?

37. Are account maintenance activities (change of address, status changes, rate changes, etc.) separated from data entry and reconciling duties?
38. Do all internal entries, other than service charges, require the approval of appropriate supervisory personnel?
39. If not included in the internal/external audit program, are employees’ and officers’ accounts, accounts of their business interests, and accounts controlled by them periodically reviewed for unusual or prohibited activity?
40. For unidentified deposits:
 - a. Are deposit slips kept under dual control?
 - b. Is their disposition approved by an appropriate officer?
41. For returned checks, unposted items, and other rejects:
 - a. Are daily listings of such items prepared?
 - b. Are all items reviewed daily and is disposition of items required within a reasonable time period? If so, indicate the time period.
 - c. Are reports prepared for management showing items not disposed of within the established time frames?
42. Are accounts with a “hold-balance” status—those accounts on which court orders have been placed, those pledged as security to

- customers' loans, those pending the clearing of a large check, and those where the owner is deceased "blocked-out" for transactions unless approved by appropriate management?
43. For signature cards on deposit accounts:
- Are procedures in effect to guard against the substitution of false signatures? Describe the procedures.
 - Are signature cards stored to preclude physical damage?
 - Are signatures compared for withdrawals and cashed checks? Describe the procedures.
44. Are separate general ledger accounts maintained for each type of official check?
45. As to the types of checks issued:
- Are multicopy checks and certified check forms used? If not, are detailed registers of disbursed checks maintained?
 - Are all checks prenumbered and issued in sequence?
 - Is check preparation and issuance separate from recordkeeping?
 - Is the signing of checks in advance prohibited?
 - Do procedures prohibit issuance of a check before the credit is processed?
46. Is the list authorizing branch personnel to sign official checks kept current? Does the list include changes in authorization limits, delete employees who no longer work at the branch, and indicate employees added to the list?
47. Are appropriate controls in effect over check signing machines (if used) and certification stamps?
48. Are voided checks and certified check forms promptly defaced and filed with paid checks?
49. If reconcilements are not part of the overall deposit reconciliation function:
- Are outstanding checks listed and reconciled regularly to the general ledger? If so, how often?
 - Is permanent evidence of reconcilements maintained?
 - Is there clear separation between preparation of checks, data entry, and reconciliation?
 - Are the reconcilements reviewed regularly by an authorized officer?
 - Are reconciliation duties rotated on a formal basis in branches where size precludes full separation of duties between data entry and reconciliation?
 - Are authorized signatures and endorsements checked by the filing clerk?
50. For supplies of official checks:
- Are records of unissued official checks maintained centrally and at each location storing them?
 - Are periodic inventories of unissued checks independently performed?
 - Do the inventories include a description of all checks issued out of sequence?
 - If users are assigned a supply, is that supply replenished on a consignment basis?
51. Are procedures in effect to preclude certification of checks drawn against uncollected funds?

CONCLUSION

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

Deposit Accounts

Audit Guidelines

Effective date July 1997

Section 3230.5

It should be noted that some audit guidelines may not be easily implemented due to the foreign residence of many branch customers. Therefore, the examiner should exercise judgment in implementing these guidelines.

1. Test the addition of all trial balances and the reconciliation to the general ledger.
 2. Using appropriate techniques, sample deposits of all types from their respective trial balances and:
 - a. Where appropriate, verify that essential account documentation contains, in a conspicuous manner, disclosure of the accounts' noninsured FDIC status.
 - b. Where necessary, prepare and mail confirmation forms, followed by second requests, to selected depositors.
 - c. Follow up on any no-replies or exceptions and resolve differences.
 3. For transaction accounts selected in step 2:
 - a. Verify the computation of service charges for at least one account from each type of transaction account selected and trace them to the appropriate income account.
 - b. Determine, on a test basis, if insufficient funds and overdraft charges are properly collected and trace them to the appropriate income account.
 - c. Determine the reasons for statements noted for "no mail" or "hold for pick up" and examine appropriate authorization signed by the customer.
 - d. Determine if a properly signed authority to charge is in evidence for accounts that have an automatic deduction by the branch.
 - e. Investigate branch-controlled accounts, such as dealers' reserves and cash/collateral accounts, to determine the validity of entries and of notification procedures to the customer of activity.
 - f. Determine if unidentified funds are properly segregated, that disposition is on a timely basis, and that items are transferred to a dormant account after one year.
 - g. Mail cut-off statements to include debit and credit memos and drafts, and mail an appropriate reconciling form to due to banks accounts selected. Have the reconciliation completed and returned. Investigate significant items used to reconcile and follow through to disposition.
 - h. Review the reports on drawings against uncollected funds and significant changes to determine possible kiting. Request statements and copies of checks and deposit media to further investigate those selected. If the period for preparing uncollected funds reports is not at least 3 days, perform the following steps:
 - Look at 5 days of reports on uncollected funds, large balances, and significant changes for unusual depositor activity. Select account names and numbers that appear on the reports twice or more and eliminate large depositors who are known to deposit cash or their own checks to corporate clearing accounts.
 - For the remaining accounts, review canceled checks and deposit slips or cash letter items to determine if checks paid and checks deposited are controlled by the same or related parties.
 - i. Determine that collections deposited in escrow funds are properly credited and that debits made against the account are for proper disbursements.
 - j. Review the debit and credit entries made on dormant accounts and determine validity and conformity to branch policy.
4. For time deposit accounts selected in step 2:
 - a. Determine the reasons for savings account statements noted for "hold for pick-up" or "no mail" and examine appropriate authorizations signed by the customers.
 - b. Determine that accounts pledged are noted on the trial balance to prevent withdrawal of funds without officer approval.
 - c. Review the debit and credit entries to dormant accounts and determine validity and conformity to branch policy.
 - d. Verify and detail the written contracts between the branch and its trust department regarding the trust department's time open account.
 - e. Determine if unidentified funds are properly segregated and if disposition is on a timely basis. Ensure that items are trans-

ferred to a dormant account after one year.

5. For official checks:

- a. If accounts are on computer, reconcile the cut-off statements as of the audit date to bookkeeping totals and run a list of duplicate outstanding checks.
- b. If accounts are manual, run a tape listing of the outstanding checks or the check register and balance to the general ledger totals.
- c. Review the copies of the outstanding checks for unusual items, stale-dated checks or any checks to persons or organizations that may be in violation of the Foreign Corrupt Practices Act or Federal Campaign Acts.
- d. Determine that stale checks are segregated and review the entries to ascertain validity.
- e. Determine that all outstanding checks have been included as liabilities by controlling paid checks for a number of days after the audit has begun and:
 - Indicate any checks paid before the liability was posted.
 - Inspect the paid checks for authorized signatures and endorsements.
- f. Determine if the branch is issuing checks in numerical sequence and make an

inventory of unissued checks by type. Reconcile the inventory to control ledger and resolve any differences.

6. Compare the accounts selected from the last audit to the current trial balance to determine if any of those accounts were closed or, if none were noted, select accounts from the closed account list and send confirmations.
7. Review stop-payment orders and compare a representative number to the trial balance to determine if accounts are properly noted.
8. Obtain or prepare a schedule showing the accrued interest balances and the deposit balances at each quarter-end since the last audit and investigate significant fluctuations or trends.
9. Test interest expense by computing interest expense based on average deposits and interest rates on a quarterly basis. Compare the computed amount to the actual recorded expenses.
10. If the branch uses prenumbered CD forms, determine that certificates are issued in numerical order. Inventory the unissued certificates and reconcile the inventory to the control list and resolve any differences.

Head office and other offices of the foreign banking organization (FBO) frequently serve as a primary funding source for a branch, in which case the branch will be in a net due to position with related offices. This situation is commonly found in a wholesale branch or a branch that is restricted by its license from accepting deposits. Funding for these offices is typically provided by related offices and/or interbank borrowings. A retail branch, on the other hand, may be able to accept deposits and thus be a net provider of funds to related offices or in a net due from position. Examiners will find that the overall level, nature, and significance of the branch's funding relationship with related offices is influenced by a number of factors, including comparative funding costs in the home country versus the United States and the branch's role, if any, in the overall U.S. funding strategy of the FBO. The examiner's role is to evaluate these factors, identify any concerns, and recommend corrective action, if appropriate.

The evaluation of the branch's funding relationship with related parties is part of the overall evaluation of the branch's liquidity position and should thus be conducted jointly. This section provides specific guidance on the interoffice funding aspect of liquidity, which should be supplemented by referring to the Funds Management and Liquidity section of this manual.

To evaluate a funding relationship between a branch and its related offices or affiliates, examiners should begin by reviewing the branch's most recent quarterly call report-Report of Assets and Liabilities (FFIEC 002), the annual assessment of the FBO's combined U.S. operations, and the FBO's annual strength-of-support assessment. A review of recent FFIEC 002 reports will give the examiner information on the branch's historical level and trend in interoffice funding, which should be used in discussions with management on the nature of the branch's future interoffice funding position. Schedule M of the call report summarizes the gross due from/due to position with related parties and shows whether the branch is in a net due to or due from related parties position.

For FBOs with multiple U.S. operations, the U.S. operations assessment should provide information on the past level and flow of funds among its combined U.S. operations, which should also provide a basis for reviewing the

branch's current and future interoffice funding position, if any. In conducting this review, special attention should be paid to any funding relationship between the branch and a U.S. affiliate bank owned or controlled by the FBO. Such a relationship should be scrutinized to verify compliance with Sections 23A and 23B of the Federal Reserve Act. If any apparent violations are noted, they should be referred to the appropriate regulator.

The FBO's annual strength-of-support assessment also provides a basis for reviewing the branch's net due from/due to position. The strength-of-support assessment is an important factor to consider when the branch is in a net due from position. In developing these assessments, the U.S. banking supervisors make determinations about the financial strength of an FBO as well as the adequacy of home country supervision and the overall condition of the home country financial system. The strength-of-support assessment is considered when reviewing branches in a net due from position. (See the Strength-of-Support Assessment for Foreign Banking Organizations section of this manual for more guidance on this subject.) If necessary, the branch may be required to maintain a net due to related parties position or may be subjected to other prudential limitations, including asset maintenance requirements and growth restrictions.

From a supervisory viewpoint, a net due to position is regarded favorably because it provides a cushion for nonrelated depositors and creditors. A net due from position with related parties should be reviewed carefully. The review should consider any information on the underlying assets represented by a net due from related party account. For example, the due from head office account may be used to fund export financing from the home country with payment of the head office account scheduled to come from the receiving party.

In addition to providing funding to related entities, branches may also provide U.S. dollar clearing services. Such transactions would flow through the due from/due to accounts and would consist of checks and other clearing items denominated in U.S. dollars. The branch would, in turn, clear and process the items typically through its U.S. correspondent bank for payment.

The due from/due to accounts may also contain allocations for loan loss reserves and other

contingencies, which would normally flow through earnings and be deducted from capital in a stand-alone operation. Such allocations must be identified and fully explored by the examiners in order to ensure that the branch's financial risks are being covered.

The branch's current period profit and loss is included in the due from/due to subledger accounts with a due to a (credit) balance representing profit and a due from (debit) balance representing a loss. Accumulated but unremitted profit or accumulated but unreimbursed loss also may be included in this account. Note that this situation only applies to the profit and loss segment of the accounts. For example, a very profitable branch could have a net due from related parties position for reasons related to funding but the profit and loss subledger of this account should reveal a due to (profit) balance.

Due from/due to accounts are sometimes used to effect asset transfers from one office to another. Such transfers should be scrutinized and reconciled to ensure propriety. For example, problem loans may be transferred to head office, offshore, or other U.S. and non-U.S. branches. Such transfers should be revealed in the due from/due to accounts, and should be communicated to the examiner-in-charge.

A branch with an asset maintenance requirement will need to keep accurate daily records of the due from/due to related office positions in order to accurately track and report its adherence to the asset maintenance requirement to the regulators. The gross due from/due to related office positions are factored into the computation for the asset maintenance requirement. (See the Asset Maintenance section of this manual for more details on this subject.)

Due From/Due To Related Offices

Examination Objectives

Effective date July 1997

Section 3240.2

1. To determine if the policies, practices, procedures, and internal controls regarding due from/due to accounts are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines from head office.
3. To evaluate the nature of all related accounts to determine character, volatility, level, flow of funds, and compliance with appropriate laws.
4. To determine the scope and adequacy of the audit function with respect to the branch's related parties position.
5. To evaluate the branch's net due from/due to position with related parties in relation to the FBO's strength-of-support assessment and the overall assessment of its combined U.S. operations.
6. To determine that all due from and due to accounts are reasonably and accurately reported.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Due From/Due To Related Offices Examination Procedures

Effective date July 1997

Section 3240.3

1. Determine the related parties position in accordance with the instructions to the Report of Assets and Liabilities.
2. Review the FFIEC 002 report and the appropriate due from/due to schedule and reconcile the figures to the general ledger to ensure accuracy.
3. Obtain a listing of any deficiencies noted in the latest review conducted by internal/external auditors with respect to the branch's related parties position, and determine if appropriate corrections have been made.
4. Review the branch prepared reconciliation of related party accounts, match the closing balances to the general ledger and the cut-off statement, and ensure that departmental controls over entries to the proper accounts within the general ledger are being followed, then:
 - a. Determine the reasonableness of any unusual items noted in the reconciliation.
 - b. Determine if any old open items have been charged off and, if so, were the charge-offs appropriate and within head office policy.
 - c. Determine if any large or unusual items are outstanding, and review related correspondence.
 - d. Determine if any overdrafts exist in related party accounts, and determine how these overdrafts are monitored and approved by head office. Share this information with the examiner evaluating loans.
 - e. Retain custody of all trial balances, only if necessary and practical.
5. For each account, determine the purpose (e.g., funding, lending, clearing, reserve allocation, etc.) and the level of volatility. Ensure that the purpose of the account is consistent with the balances and the volatility.
6. Identify what interest, if any, is paid and received on due from/due to accounts to determine if the rates are above or below market rates. Share this information with the examiner evaluating earnings.
7. For accounts that represent reserves, determine the precise nature of these reserves, identifying all activity since the previous examination. Share this information with the examiner-in-charge and the examiners in charge of loan administration and earnings, if applicable.
8. Determine if any transfers of loans have occurred between examinations. If so, review the entries and share this information with the examiner in charge of loan review.
9. Review the workpapers associated with the profit and loss accounts to ensure that reported earnings or losses are properly reflected in the due from/due to accounts with head office. Note whether provisions for general reserves are taken through earnings.
10. If the branch is in a net due from position, determine if it represents a concentration (greater than or equal to 25 percent) of the branch's net assets and assess the potential risks of such a concentration.
11. Identify any office on which the branch relies heavily for funding and share this information with the examiner reviewing liquidity.
12. If the branch is operating under a supervisory agreement that limits net due from positions or imposes an asset maintenance requirement, test check for accuracy of reporting to the regulators.
13. Update the workpapers with any information that will facilitate future examinations.

Due From/Due To Related Offices Internal Control Questionnaire

Effective date July 1997

Section 3240.4

Review the branch's controls, policies, practices, and procedures for obtaining and servicing loans, placements, deposits, and borrowed funds from related parties. The branch's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

1. Does the branch have in place a written policy approved by branch and head office management that:
 - a. Outlines the objectives of due from/due to related accounts?
 - b. Describes the branch's philosophy relative to funding and clearing needs, reserve policies, overdraft policies and approval limits, and proper recognition of profits and losses?
 - c. Provides a system of reporting requirements to monitor interoffice activity?
 - d. Provides for review and revision of established policy at least annually?
2. Does the branch maintain subsidiary records for each related office?
3. Is the preparation, addition, and posting of the subsidiary related accounts records performed or adequately reviewed by persons who do not also:
 - a. Handle cash, telex, or wire transfers?
 - b. Issue official checks and drafts?
 - c. Prepare all supporting documents required for payment of debt?
4. Are subsidiary related account records reconciled with the general ledger accounts at an interval consistent with interoffice activity and are the reconciling items investigated by persons, who do not also:
 - a. Handle cash, telex, or wire transfers?
 - b. Prepare general ledger entries.
 - c. Prepare or post to the related party's borrowed funds records?
5. Are interest computations, if any, checked by persons who do not have access to cash?
6. Do monthly reports furnished to the head office reflect the activity of related accounts, including amounts outstanding, overdrafts, interest rates, interest paid to date, and anticipated future activity?
7. Is the foregoing information an adequate basis for evaluating internal control in that

there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.

8. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

In the event the branch is in a net due from position greater than or equal to 25 percent of net assets, conduct the following procedures.

9. Carefully review the FBO's strength-of-support assessment to determine whether any concerns exist with respect to its general ability to support its U.S. operations. If so, determine the extent to which the branch depends on head office or related parties for contingency funding, and any effect on the ability of the branch to meet third party obligations. Discuss any concerns with the examiner-in-charge for further guidance.
10. If the branch is in a net due from position greater than or equal to 25 percent of net assets with an affiliate located in a country other than its home country, determine:
 - a. If the affiliate is a financial institution that has been assigned a strength-of-support assessment or has received a rating by an independent agency.
 - b. If the affiliate is not a financial institution, discuss the nature and future of this funding relationship with branch management. Discuss any concerns with the examiner-in-charge.
11. Is the branch reconciling its accounts with related parties at an interval consistent with the interoffice activity, and is there a system to identify and monitor old items or large items?
12. Are extensions of credit being granted to or are loans being transferred to related parties? Are the credit extensions performing? At the time of transfer, were the assets performing?
13. Are the due from time deposits with related parties performing?
 - a. Are the placements continually renewed or is there actual payment at maturity?

- b. If the branch is providing funding to an offshore related financial institution, determine the purpose of the funding and its utilization.
- Is the entity well capitalized?
 - Are the funds used to lend to ICERC classified countries? Are these loans to finance trade transactions and are these loans performing?
 - Is the entity purchasing problem loans from the branch? If so, this relationship should be closely scrutinized because the branch may be funding the sale of its problem assets through the placement of funds with the purchasing entity.
14. Does the net due from related parties position represent a concentration of transfer risk to any one country that could have a significant impact on the repayment of the branch's third party liabilities?
15. If the branch is operating under an asset maintenance requirement, is it appropriately monitoring and accurately reporting due from/due to related office positions to the regulators in the asset maintenance computation?

Due From/Due To Related Offices

Audit Guidelines

Effective date July 1997

Section 3240.5

1. Using an appropriate sampling technique, select items for review of supporting documentation, including terms, balances, and other appropriate details, and request a positive confirmation from the related office. Control all answered confirmations and investigate any reported differences. Include all confirmations in the workpapers and document the disposition of all exceptions or no-replies.
2. Examine supporting documents for accuracy and trace applicable entries, including proceeds, to detail records and to the general ledger.
3. Test check interest computations for accuracy and trace entries to appropriate accounts.
4. Examine transactions for consistency with the stated purpose of the related accounts.