WHAT'S IN THIS SECTION

This section was revised as of January 2008 to incorporate references to the Federal Reserve Board's Regulation W, primarily with regard to the bank holding company (BHC) inspection process. The section includes also a discussion of the mandatory reporting of certain intercompany transactions on the FR Y-8, The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates, *and its instructions. The mandatory report is to be submitted quarterly to the Federal Reserve by (1) all top-tier BHCs, including financial holding companies, and (2) all foreign banking organizations that directly own a U.S. subsidiary bank. The examiner's inspection responsibilities are discussed.*

2020.0.1 ANALYSIS OF INTERCOMPANY TRANSACTIONS

The analysis of intercompany transactions between a parent company, its nonbank subsidiaries, and its bank subsidiaries is primarily intended to assess the nature of the relationships between these entities and the effect of the relationships on the subsidiary insured depository institutions (IDIs). IDIs include any state bank, national bank, trust company, or banking association and any institution that takes deposits that are insured by the Federal Deposit Insurance Corporation, including savings associations. Both the legal and financial ramifications of such transactions are areas of concern. Certain intercompany transactions are subject to the provisions of section 23A or 23B (or both) of the Federal Reserve Act and the Federal Reserve Board's Regulation W. Section 23A of the Federal Reserve Act is one of the most important statutes on limiting exposures to individual institutions and protecting the federal safety net. Several types of intercompany transactions and the primary regulatory concerns of each are presented below.

Dividends paid by subsidiaries to the parent. Dividends are a highly visible cash outflow by subsidiaries. If the dividend payout ratio exceeds the level at which the growth of retained earnings can keep pace with the growth of assets, the subsidiary's capital ratios will deteriorate. These dividends may also have a negative effect on the subsidiary's liquidity position.

Transactions with affiliates. Transactions between subsidiary IDI affiliates is another area of potential abuse of subsidiary banks. Regulatory concern centers on the quantitative limits and collateral restrictions on certain transactions by subsidiary banks with their affiliates. These restrictions are designed to protect subsidiary IDIs from losses resulting from transactions with affiliates.

Fees paid by subsidiaries. Management or service fees are another cash outflow of bank subsidiaries. These fees may be paid to the parent, the nonbank subsidiaries, or, in some cases, to the other bank subsidiaries. Regulatory concern focuses on whether such fees are reasonable in relation to the services rendered and on the financial impact of the fees on the bank subsidiaries.

Tax allocation. How a bank holding company organization determines to allocate taxes among its component companies involves questions of both the magnitude and timing of the cash-flow effects. Unreasonable or untimely tax payments or refunds to the bank can have an adverse effect on the financial condition of the banking subsidiaries.

Purchases or swaps of assets. Asset purchases or swaps between a bank and its affiliates can create the potential for abuse of subsidiary banks. Regulatory concern focuses on the fairness of such asset transactions and their financial impact and timing. Fairness and financial considerations include the quality and collectibility and fair values of such assets and their liquidity effects. IDIs generally are prohibited from purchasing low-quality assets from affiliates. Asset exchanges may be a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets. Improper timing or certain structurings of asset transactions also can cause them to be regarded as extensions of credit to affiliates. As such, these types of transactions could potentially violate applicable regulations and statutes.

Compensating balances. A subsidiary bank may be required to maintain excess balances at a correspondent bank that lends to other parts of the holding company organization, possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds, which may adversely affect its financial condition.

Other expense allocations. In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. Furthermore, a subsidiary bank should not pay for expenses for which it does not receive a benefit.

2020.0.2 ROLE OF THE EXAMINER

To properly assess intercompany transactions and relationships between affiliates, the examiner must make a thorough analysis of most intercompany transactions and must have a knowledge of applicable laws, regulations, and rulings. In particular, the examiner should be familiar with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W. The examiner should also be familiar with the FR Y-8, *The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates,* and its instructions. The mandatory report is to be submitted to the Federal Reserve by (1) all top-tier bank holding companies (BHCs), including financial holding companies, and (2) all foreign banking organizations that directly own a U.S. subsidiary bank. The completed quarterly reports are used by the Federal Reserve System to monitor bank exposures to affiliates and to ensure banks' compliance with section 23A of the Federal Reserve Act. With regard to the BHC's inspection, the examiner should review and verify, since the previous inspection, the BHC's accuracy and comprehensiveness in its reporting based on the FR Y-8 report form and instructions.

If a subsidiary IDI of a holding company is not a state member bank, the bank's primary regulator should determine the bank's compliance with pertinent banking laws. In reviewing the subsidiary bank's examination report, any violations of laws and regulations applicable to intercompany transactions should be noted. If the violation resulted from the actions of an affiliate, the affiliate's role should be identified and be subject to criticism in the inspection report.

Violations of banking laws discovered during the inspection should be brought to management's attention and referred to the bank's primary supervisor. However, any action or criticism levied directly on the bank should come from the bank's primary supervisor.

2020.1.01 *WHAT'S NEW IN THIS REVISED SECTION*

This section has been revised to discuss statutory amendments of sections 23A and 23B of the Federal Reserve Act resulting from the Dodd-Frank Act. One amendment involved the definition of an "affiliate," with regard to an investment fund when an insured depository institution (IDI) or one of its affiliates is an investment adviser. Also, the definition of "covered transactions" was revised to include the credit exposure resulting for derivative and securities lending and borrowing transactions between the IDI and its affiliates. In addition, the Dodd-Frank Act removed the quantitative 10 percent exemption limit between financial subsidiaries. The retained earnings of a financial subsidiary are to be included as part of the IDI's investment. The amendments were effective July 21, 2012. (See sections 608(a)(1)(A), 608(a)(1)(B), and 609(a) of the Dodd-Frank Act.)

Revised inspection objectives and inspection procedures also are included.

2020.1.05 SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT, AND REGULATION W

Section 23A of the Federal Reserve Act (FRA) restricts the ability of insured depository institutions (IDIs)[1] to engage in certain covered transactions with an affiliate. Transactions that are subject to section 23A also are subject to the provisions of section 23B of the FRA.[2] In addition to these statutory provisions, the Board issued Regulation W (the rule),[3] which implements sections 23A and 23B of the FRA. The rule provides several exemptions and combines the statutory restrictions on transactions between a member bank and its affiliates with numerous previously issued Board interpretations.

During a bank holding company inspection, transactions between an IDI and an affiliate (for example, a bank holding company parent or other nonbank subsidiary) are reviewed for compliance with sections 23A and 23B and Regulation W, as well as other banking regulations and statutes. Any violations of sections 23A and 23B of the FRA or Regulation W involving a transaction between an IDI and its affiliate that are disclosed or found during an inspection should be brought to management's attention, may be discussed in the inspection report as "Other Matters," and referred to the bank's primary supervisor. However, any action or criticism levied directly on the bank should come from the bank's primary supervisor. See also SR-03-2.

2020.1.1 SECTION 23A OF THE FEDERAL RESERVE ACT

Section 23A of the FRA (12 U.S.C. 371c) is the primary statute governing transactions between an IDI and its affiliates. Section 23A (1) designates the types of companies that are affiliates of an IDI; (2) specifies the types of transactions covered by the statute; (3) sets the quantitative limitations on an IDI's covered transactions with any single affiliate, and with all affiliates combined; (4) sets forth collateral requirements for certain transactions with affiliates; and (5) requires all covered transactions to be conducted on terms consistent with safe and sound banking practices.

2020.1.1.1 Definition of an Affiliate

In general, companies that control or are under common control with an IDI are defined by section 23A as "affiliates" of the bank. The definition includes a bank subsidiary of a bank and any company that a bank, or its subsidiaries or affiliates, sponsors and advises on a contractual basis.[4] Affiliates, for example, may

1. By their terms, sections 23A and 23B apply to banks that are members of the Federal Reserve System ("member banks"). Other federal laws subject FDIC-insured nonmember banks and FDIC-insured thrifts to sections 23A and 23B in the same manner and to the same extent as if they were member banks. (See 12 U.S.C. 1828(j) and 12 U.S.C.1468(a)(4)). The statute also states that most subsidiaries of a member bank are to be treated as part of the member bank itself for purposes of sections 23A and 23B. Because the statute and regulation apply to all insured depository institutions, this section will refer to the subject institutions as insured depository institutions (IDIs).

2. Federally insured savings associations also are subject to sections 23A and 23B as if they were banks.

3. In this section of the manual, Regulation W is referred to as "the rule" or to a specific numbered section of the rule.

4. The Board has the authority to expand the definition of affiliate to include a company that has a relationship with the bank so that covered transactions between the company and

include banks, financial holding companies, savings and loan holding companies, and their subsidiaries. Banks, savings associations, and nonbanking companies that are under common individual control or a group of individuals with the bank also are affiliates for the purposes of section 23A. Any investment fund with respect to which a member bank or affiliate thereof is an investment adviser. See section 608(a)(1)(A) of the Dodd-Frank Act. In addition, any transaction by an IDI with any person is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are transferred to, or used for the benefit of, the affiliate. With respect to any IDI within a holding company, its affiliates include, among others, its parent, the parent's subsidiaries, and other companies directly or indirectly controlled by the bank's or holding company's shareholders. Specifically, Regulation W defines[5] an affiliate as—

1. any company that controls[6] the IDI and any other company that is controlled by the company that controls the IDI;
2. any bank subsidiary of the IDI;
3. any company—
   - that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the IDI; or
   - in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the IDI or any company that controls the IDI;
4. any company (including a real estate investment trust) that is sponsored and advised on a contractual basis by the IDI or any subsidiary or affiliate of the IDI;
5. any investment company, with respect to which an IDI or any affiliate thereof is an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940;
6. any investment fund for which the IDI or any affiliate of the IDI serves as an investment adviser, if the IDI and its affiliates own or control, in the aggregate, more than 5 percent of any class of voting securities or of the equity capital of the fund;
7. a depository institution that is a subsidiary of the IDI;
8. a financial subsidiary of the member bank;
9. any company in which a holding company of the IDI owns or controls, directly or indirectly, or acting through one or more other persons, 15 percent or more of the equity capital pursuant to the merchant banking authority in section 4(k)(4)(H) or (I) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H) or (I));
10. any partnership for which the IDI or any affiliate of the IDI serves as a general partner or for which the IDI or any affiliate of the IDI causes any director, officer, or employee of the member bank or affiliate to serve as a general partner;
11. any subsidiary of an affiliate described in paragraphs (a)(1) through (10) of section 223.2 of Regulation W; and
12. any company that the Board, or the appropriate federal banking agency for the IDI, determines by regulation or order to have a relationship with the IDI or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship, to the detriment of the IDI or its subsidiary.

The following generally are not considered to be affiliates of an IDI:

1. a nonbank subsidiary of the IDI (other than a financial subsidiary), unless the Board determines not to exclude such a subsidiary;
2. a company engaged solely in holding the IDI's premises;
3. a company engaged solely in conducting a safe deposit business;
4. a company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and
5. a company in which control arises from the exercise of rights arising out of a bona fide debt previously contracted (for the period of time specified by section 23A).

the bank may be affected by the relationship to the detriment of the bank.

5. See 12 C.F.R. 223.2.

6. By statute, "control" is defined as the power to (1) vote 25 percent or more of the voting shares of a company, excluding situations in which the stock is controlled in a fiduciary capacity; (2) elect a majority of the directors of a company; or (3) exercise a controlling influence over a company. Control is discussed in more detail at 2020.1.3.1.

2020.1.1.2 Definition of Affiliates by Type of Entity

2020.1.1.2.1 Investment Funds Advised by the Member Bank or an Affiliate of the Member Bank

Regulation W includes as an affiliate any company that is sponsored and advised on a contractual basis by the IDI or any of its affiliates as well as any investment company for which the IDI or its affiliate serves as an investment adviser, as defined in the Investment Company Act of 1940 (the 1940 Act). In Regulation W, the Board used its statutory authority to define as an affiliate any investment fund—even if not an investment company for purposes of the 1940 Act—for which the IDI or an affiliate of the IDI serves as an investment adviser, if the IDI or an affiliate of the IDI owns or controls more than 5 percent of any class of voting securities or similar interests of the fund.

Many investment funds that are advised by an IDI (or an affiliate of an IDI) are affiliates of the IDI under section 23A because the funds either are investment companies under the 1940 Act or are sponsored by the IDI (or an affiliate of the IDI). The IDI or its affiliate, in some instances, however, may advise but not sponsor an investment fund that is not an investment company under the 1940 Act.[7] The advisory relationship of an IDI or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is an investment company under the 1940 Act.[8] The Dodd-Frank Act treats any investment fund as an affiliate if the IDI or an affiliate of the IDI serves as an investment adviser to the fund.

2020.1.1.2.2 Financial Subsidiaries

In 1999, the Gramm-Leach-Bliley Act (the GLB Act) authorized banks to own ‘‘financial subsidiaries’’ that engage in activities not permissible for the parent bank to conduct directly, such as underwriting and dealing in bank-ineligible securities. The GLB Act amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank and thus subjected covered transactions between the bank and a financial subsidiary to the limitations of sections 23A and 23B.

Section 23A defines a financial subsidiary as a subsidiary of any bank (state or national) that is engaged in an activity that is not permissible for national banks to engage in directly (other than a subsidiary that federal law specifically authorizes national banks to own or control). Specifically, a ‘‘financial subsidiary’’ is defined as ‘‘any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.’’[9] (See 12 U.S.C. 371c(e)(1).) Section 5136A, in turn, defines a financial subsidiary as any company that is controlled by one or more member banks, other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly (and subject to the terms and conditions that apply to national banks) or (2) a subsidiary that national banks are specifically authorized to control by the express terms of a federal statute (other than section 5136A of the Revised Statutes), such as an Edge Act corporation or a small business investment company (SBIC).[10] (See 12 U.S.C. 24a(g)(3).) Section 5136A also prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities.[11] (See 12 U.S.C. 24a(a)(2).)

The Dodd-Frank Act amended section 23A as it relates to financial subsidiaries of a bank. First, the 10 percent quantitative limit of section 23A between a bank and any individual affiliate applies to covered transactions between a bank and a financial subsidiary of the bank. In addition, for purposes of section 23A, the amount of a bank’s investment in its financial subsidiary includes the retained earnings of the financial subsidiary. See section 609(a) of the Dodd-Frank Act.

Section 23A generally applies only to transactions between (1) a bank and an affiliate of the bank and (2) a bank and a third party in which some benefit of the transactions accrues to an

7. 12 U.S.C. 371c(b)(1)(E).

8. An investment fund typically escapes from the definition of investment company under the 1940 Act because it (1) sells interests only to a limited number of investors or only to sophisticated investors or (2) invests primarily in financial instruments that are not securities. An IDI may face greater risk from the conflicts of interest arising from its relationships with an investment fund that is not registered than an investment company under the 1940 Act because the 1940 Act restricts transactions between a registered investment company and entities affiliated with the company’s investment adviser. (See 15 U.S.C. 80a-17).

9. 12 U.S.C. 24a(g)(3).

10. 12 U.S.C. 24a(a)(2).

11. 12 U.S.C. 371c(e)(1).

affiliate of the bank. The statute generally does not apply to transactions between two affiliates. Section 23A establishes two special anti-evasion provisions, however, that govern transactions between a financial subsidiary of a bank and another affiliate of the bank. First, the FRA provides that any purchase of, or investment in, the securities of a bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem a loan or other extension of credit made by a bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasion.

2020.1.1.2.2.1 Regulation W Provisions for Financial Subsidiaries

Regulation W (1) defines a financial subsidiary of a bank, (2) exempts certain companies from the definition, and (3) sets forth special valuation and other rules for financial subsidiaries. (See sections 223.2(a)(8), 223.3(p), and 223.32 of the rule.) Regulation W also includes several special rules that apply to transactions with financial subsidiaries.

Applicability of the 10 percent quantitative limit to transactions with a financial subsidiary. The 10 percent quantitative limit in section 23A applies with respect to covered transactions between a member bank and any individual financial subsidiary of the bank.[12]

Valuation of investments in securities issued by a financial subsidiary. Because financial subsidiaries of a member bank are considered affiliates of the bank for purposes of section 23A, a member bank's purchases of, and investments in, the securities of its financial subsidiary are covered transactions under the statute.[13] The Dodd-Frank Act provides that a member bank's investment in its own financial subsidiary, for purposes of section 23A, shall include the retained earnings of the financial subsidiary.[14] In light of this statutory provision, section 223.32(b) of the rule contains a special valuation provision for investments by a member bank in the securities of its own financial subsidiary.[15] Such investments must be valued at the greater of (1) the price paid by the member bank for the securities or (2) the carrying value of the securities on the financial statements of the member bank (determined in accordance with generally accepted accounting principles (GAAP) but without reflecting the bank's pro rata share of any earnings retained, or losses incurred by, the financial subsidiary after the bank's acquisition of the securities).[16]

This valuation rule differs from the general valuation rule for investments in securities issued by an affiliate in that the financial subsidiary rule permits, consistent with the GLB Act, that the carrying value of the investment be computed without consideration of the retained earnings or losses of the financial subsidiary since the time of the member bank's investment. As a result of this rule, the covered transaction amount for a member bank's investment in securities issued by its financial subsidiary generally would not increase after the investment was made except if the member bank made an additional capital contribution to the subsidiary or purchased additional securities of the subsidiary.

The following examples were designed to assist banks in valuing investments in securities issued by a financial subsidiary of the bank. Each example involves a securities underwriter that becomes a financial subsidiary of the bank after the transactions described below.

1. *Initial valuation.*
   a. *Direct acquisition by a bank.* A bank pays $500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the member bank's parent-only GAAP financial state-

12. A member bank's aggregate amount of covered transactions with any individual financial subsidiary of the bank may not exceed 10 percent of the bank's capital and surplus.

13. See section 609(a) of the Dodd-Frank Act. The Dodd-Frank Act eliminated the 10 percent quantitative limit exemption for certain covered transactions with financial subsidiaries and individual affiliates.

14. See section 609(a) of the Dodd-Frank Act.

15. The rule's special valuation formula for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in a financial subsidiary of an affiliated depository institution. Such investments must be valued using the general valuation formula set forth in section 223.23 for investments in securities issued by an affiliate and, further, may trigger the anti-evasion rule contained in section 223.32(c)(1) of the rule.

16. The rule also makes clear that if a financial subsidiary is consolidated with its parent bank under GAAP, the subsidiary under the carrying value of the bank's investment in the financial subsidiary shall be determined based on parent-only financial statements of the bank.

ments is $500. The member bank initially must value the investment at $500.

b. *Contribution of a financial subsidiary to a member bank*. The parent holding company of a bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500 and immediately contributes the shares to the member bank. The bank gives no consideration in exchange for the shares. The bank initially must value the investment at the carrying value of the shares on the bank's parent-only GAAP financial statements. Under GAAP, the bank's initial carrying value of the shares would be $500.

2. *Carrying value not adjusted for earnings and losses of the financial subsidiary*. A bank and its parent holding company engage in a transaction whereby the member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500. The bank initially values the investment at $500. In the following year, the securities underwriter earns $25 in profit, which is added to its retained earnings. The bank's investment of the shares of the underwriter is not adjusted for purposes of section 23A and Regulation W, and the bank's investment continues to be valued at $500. If, however, the member bank contributes $100 of additional capital to the securities underwriter, the bank must value the aggregate investment at $600.

Anti-evasion rules as they pertain to financial subsidiaries. Section 23A generally applies only to transactions between a bank and an affiliate of the bank and transactions between a member bank and a third party when some benefit of the transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. The GLB Act establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a member bank and another affiliate of the bank.[17] First, the GLB Act provides that any purchase of, or investment in, securities issued by a member bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem an extension of credit made by a member bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasions of the FRA or the GLB Act. Section 223.32(c) of the rule incorporates both of these provisions.

The Board exercised its authority under the second anti-evasion rule by stating that an extension of credit to a financial subsidiary of a bank by an affiliate of the bank would be treated as an extension of credit by the bank itself to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. An example of the kind of credit extension covered by this provision would be a subordinated loan to a financial subsidiary that is a securities broker-dealer in which the loan is treated as capital of the subsidiary under the SEC's net capital rules. Treating such an extension of credit as a covered transaction is appropriate because the extension of credit by the affiliate has a similar effect on the subsidiary's regulatory capital as an equity investment by the affiliate, which is treated as a covered transaction by the terms of the GLB Act (as described above). The rule generally does not prevent a BHC or other affiliate of a member bank from providing financial support to a financial subsidiary of the bank in the form of a senior or secured loan.

2020.1.1.2.3 Partnerships

IDIs fund legitimate commercial transactions through partnerships. Partnerships for which an IDI or an affiliate(s) serves as a general partner are affiliates. Regulation W also defines an affiliate of an IDI as any partnership, if the IDI or an affiliate of the IDI causes any director, officer, or employee of the IDI or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the bank.) Also, if a company, such as a bank holding company, controls more than 25 percent of the equity through a partnership, that company is an affiliate under Regulation W.

2020.1.1.2.4 Subsidiaries of Affiliates

Regulation W deems a subsidiary of an affiliate as an affiliate of the IDI.

17. GLB Act section 121(b)(1), or 12 U.S.C. 371c(e)(3).

2020.1.1.2.5 Companies Designated by the Appropriate Federal Banking Agency

Under section 223.2(a)(12), the Board or the appropriate federal banking agency for the relevant IDI (under authority delegated by the Board) can determine that any company that has a relationship with an IDI or an affiliate of the IDI, such that covered transactions by the IDI with that company may be affected by the relationship to the detriment of the IDI, is an affiliate of the IDI. The Board and the federal banking agencies can thus protect IDIs in their transactions with associated companies. An IDI may petition the Board to review any such affiliate determination made by the institution's appropriate federal banking agency under the general procedures established by the Board for review of actions taken under delegated authority.[18]

2020.1.1.2.6 Merchant Banking

The GLB Act also amended the Bank Holding Company Act (BHC Act) to permit BHCs and foreign banks that qualify as financial holding companies (FHCs) to engage in merchant banking and insurance company investment activities.[19] If an FHC owns or controls more than 25 percent of a class of voting shares of a company under the merchant banking or insurance company investment authority, the company is an affiliate of any member bank controlled by the FHC by operation of the statutory definitions contained in section 23A. The GLB Act also added paragraph (b)(11) to section 23A, which creates a rebuttable presumption that a company (''portfolio companies'') is an affiliate of a member bank, for purposes of section 23A, if the bank is affiliated with an FHC and the FHC owns or controls 15 percent or more of the equity capital of the other company pursuant to the FHC's merchant banking or insurance company investment authority[20] (section 4(k)(4)(H) or (I) of the BHC Act). (See 12 U.S.C. 371c(b)(11).)

The rule also provides three specific regulatory safe harbors from the 15 percent presumption. These safe harbors apply in situations where the holding company owns or controls more than 15 percent of the total equity of the company under the merchant banking or insurance company investment authority (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the company (thereby not meeting the statutory definition of control). The three situations are substantially identical to those listed in the Board's merchant banking regulation.[21]

The first exemption applies where no director, officer, or employee of the holding company serves as a director (or individual exercising similar functions) of the company. The second exemption applies where an independent third party controls a greater percentage of the equity capital of the company than is controlled by the holding company, and no more than one officer or employee of the holding company serves as a director (or individual exercising similar functions) of the company. The third exemption applies where an independent third party controls more than 50 percent of the voting shares of the company, and officers and employees of the holding company do not constitute a majority of the directors (or individuals exercising similar functions) of the company.[22]

These safe harbors do not require Board review or approval of the exclusion from affiliate status. Moreover, the safe harbors are not intended to be a complete list of circumstances in which the 15 percent presumption may be rebutted. The rule also provides, consistent with the GLB Act, that a holding company may rebut the presumption with respect to a portfolio company by presenting information to the Board that demonstrates, to the Board's satisfaction, that the holding company does not control the portfolio company. The Board notes that a company that qualifies as an affiliate under the 15 percent presumption and under another prong of the regulation's definition of affiliate cannot avoid affiliate status through a rebuttal of the 15 percent presumption (either by qualifying for

18. See 12 C.F.R. 265.3.

19. GLB Act, section 103(a); 12 U.S.C. 1843(k)(4)(H) and (I).

20. GLB Act, section 121(b)(2). As noted above, this rebuttable presumption applies only if the affiliated FHC owns or controls 15 percent or more of the company's equity capital under the merchant banking or insurance company investment authorities. The Board noted, however, that under existing Board precedents, a BHC may not own any shares of a company in reliance on section 4(c)(6) or 4(c)(7) of the BHC Act where the holding company owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company.

21. See 12 C.F.R. 225.176(b)(2) and (3).

22. For purposes of these safe harbors, the rule provides that the term ''holding company'' includes any subsidiary of the holding company, including any subsidiary bank of the holding company. Accordingly, if a director of a subsidiary bank or nonbank subsidiary of an FHC also serves as a director of a portfolio company, the first safe harbor, for example, would be unavailable.

one of the three regulatory safe harbors or by obtaining an ad hoc rebuttal of the presumption from the Board).

An FHC generally is considered to own or control only those shares or other ownership interests that are owned or controlled by itself or by a subsidiary of the holding company. The rule clarifies that, for purposes of applying the presumption of affiliation described above, an FHC that has an investment in a private equity fund (as defined in the Board's merchant banking rule) will not be considered indirectly to own the equity capital of a company in which the fund has invested unless the FHC controls the private equity fund (as described in the Board's merchant banking rule).

2020.1.1.2.7 Companies that are not Affiliates

Under the terms of section 23A, subsidiaries of an IDI generally are not treated as affiliates of the member bank.[23] The statute contains two specific exceptions to this general rule: financial subsidiaries of an IDI and IDI subsidiaries of an IDI are treated as affiliates of the parent IDI. The statute provides that the Board may determine that other subsidiaries of an IDI should be treated as affiliates in appropriate circumstances.[24]

Under section 223.2(b)(1)(iii) of the rule, certain joint venture subsidiary companies of an IDI are treated as affiliates. A subsidiary of an IDI is treated as an affiliate if one or more affiliates of the IDI, or one or more controlling shareholders of the IDI, directly control the joint venture. For example, if an IDI controls 30 percent of company A and an affiliate controls 70 percent of Company A, then Company A is an affiliate. This provision also covers situations in which a controlling natural-person shareholder or group of controlling natural-person shareholders of the IDI (who, as natural persons, are not themselves section 23A affiliates of the IDI) exercise direct control over the joint venture company. The rule's treatment of certain IDI-affiliate joint ventures as affiliates does not apply to joint ventures between an IDI and any affiliated IDIs. For example, if two affiliated IDIs each own 50 percent of the voting common stock of a company, the company would continue to qualify as a subsidiary and not an affiliate of each IDI (despite the fact that an affiliate of each IDI owned more than 25 percent of a class of voting securities of the company). The Board has retained its authority to treat such joint ventures as affiliates under section 23A on a case-by-case basis.

2020.1.1.2.8 Employee Benefit Plans

Regulation W clarifies, under section 223.2(b)(1)(iv), that an employee stock option plan (ESOP), of an IDI or an affiliate of the IDI cannot itself avoid classification as an affiliate of the member bank by also qualifying as a subsidiary of the member bank. Many, but not all, ESOPs, trusts, or similar entities that exist to benefit shareholders, members, officers, directors, or employees of an IDI or its affiliates are treated as affiliates of the IDI for purposes of sections 23A and 23B. The ESOP's share ownership or the interlocking management between the ESOP and its associated IDI (or BHC), in many cases, exceeds the statutory thresholds for determining that a company is an affiliate. For example, if an ESOP controls more than 25 percent of the voting shares of the member bank or bank holding company, the ESOP is an affiliate.

The relationship between an IDI and its (or its) affiliate's ESOP generally warrants coverage by sections 23A and 23B. IDIs have made unsecured loans to their ESOPs or their affiliates' ESOP or have guaranteed loans to such ESOPs that were made by a third party. These ESOPs, however, generally have no means to repay the loans other than with funds provided by the IDI. In addition, even if the ESOP's ownership control does not warrant treatment as an affiliate, the issuance of holding company shares to an ESOP that is funded by a loan from the holding company's subsidiary IDI could be used as a vehicle by the IDI to provide funds to its parent holding company when the IDI is unable to pay dividends or is otherwise restricted in providing funds to its holding company. The attribution rule (12 C.F.R. 223.16) subjects such transactions to the restrictions of sections 23A and 23B.

23. See 12 U.S.C. 371c(b)(1)(A) and (b)(2)(A). Section 23A defines a subsidiary of a specified company as a company that is controlled by the specified company. Under the statute, a company controls another company if the first company owns or controls 25 percent or more of a class of voting securities of the other company, controls the election of a majority of the directors of the other company, or exercises a controlling influence over the policies of the other company (12 U.S.C. 371c(b)(3) and (4)).

24. 12 U.S.C. 371c(b)(2)(A).

2020.1.2 QUANTITATIVE LIMITS

Section 23A(a)(1)(A) states that an IDI may engage in a covered transaction with an affiliate only if in the case of any affiliate

1. the IDI limits the aggregate amount of covered transactions to that particular affiliate to not more than 10 percent of the IDI's capital stock and surplus and
2. the IDI limits the aggregate amount of all covered transactions with all of its affiliates to 20 percent of the IDI's capital stock and surplus.

The rule's interpretation of the 10 percent limit is consistent with the statutory language.[25] An IDI that has crossed the 10 percent threshold with one affiliate may still conduct additional covered transactions with other affiliates, if transactions with all affiliates would not exceed 20 percent of the IDI's capital stock and surplus. An IDI is prohibited from engaging in a new covered transaction with that affiliate if the IDI's transactions would exceed the 10 percent threshold with that affiliate or if the level of covered transactions with all its affiliates exceeded the 20 percent threshold. The rule generally does not require an IDI to unwind existing covered transactions if the member bank exceeds the 10 percent or 20 percent limit because its capital declined or a preexisting covered transaction increased in value.

The Board strongly encourages IDIs with covered transactions in excess of the 10 percent threshold with any affiliate to reduce those transactions before expanding the scope or extent of the member bank's relationships with other affiliates.

2020.1.3 CAPITAL STOCK AND SURPLUS

Under section 23A, the quantitative limits on covered transactions are based on the "capital stock and surplus" of the IDI. An IDI's capital stock and surplus for purposes of section 23A of the FRA is—

1. the sum of tier 1 and tier 2 capital included in an institution's risk-based capital under the capital guidelines of the appropriate federal banking agency, based on the institution's most recent consolidated FFIEC Reports of Condition and Income (Call Report) filed under 12 U.S.C. 1817(a)(3);
2. the balance of an institution's allowance for loan and lease losses not included in its tier 2 capital for purposes of the calculation of risk-based capital by the appropriate federal banking agency (based on the institution's most recent consolidated Call Report of Condition and Income that is filed under 12 U.S.C. 1817(a)(3)); and
3. the amount of any investment in a financial subsidiary that counts as a covered transaction that is required to be deducted from the IDI's regulatory capital.[26]

Examiners can determine the amount of the quantitative limits.[27]

2020.1.3.1 Determination of Control

The definition of "control" is similar to the definition used in the BHC Act. Under the rule, a company or shareholder shall be deemed to have control over another company if—

- such company or shareholder, directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;
- such company or shareholder controls in any manner the election of a majority of the directors or trustees (or general partners or individuals exercising similar functions), of the other company; or
- the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.[28]

In addition, three additional presumptions of control are provided under the rule. First, a company will be deemed to control securities, assets, or other ownership interests controlled by any subsidiary of the company.[29] Second, a company that controls instruments (including options and warrants) that are convertible or exercisable, at the option of the holder or owner,

25. Sections 223.11 and 223.12 of the rule set forth these quantitative limits.

26. See section 223.3(d) of the rule (12 C.F.R. 223.3(d)).
27. Examiners should refer to the IDI's most recent Call Report.
28. See section 223.3(g) of the rule (12 C.F.R. 223.3(g)).
29. See 12 C.F.R. 225.2(e)(2)(i).

into securities, will be deemed to control the securities.[30] Third, a rebuttable presumption provides that a company or shareholder that owns or controls 25 percent or more of the equity capital of another company controls the other company, unless the company or shareholder demonstrates otherwise to the Board based on the facts and circumstances of the particular case.[31] Such a presumption of control is particularly appropriate in the section 23A context because a BHC may have incentives to divert the resources of a subsidiary IDI to any company in which the holding company has a substantial financial interest, regardless of whether the holding company owns any voting securities of the company.

Section 23A and the rule provide that no company shall be deemed to own or control another company by virtue of its ownership or control of shares in a fiduciary capacity except (1) when a company that is controlled, directly or indirectly, by a trust for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, a member bank, or (2) if the company owning or controlling such shares is a business trust.

2020.1.4 COVERED TRANSACTIONS

The restrictions of section 23A do not apply to every transaction between an IDI and its affiliates; section 23A only applies to seven "covered transactions" between an IDI and its affiliates.[32]

A covered transaction under section 23A of the FRA means—

1. a loan or extension of credit by an IDI to an affiliate;
2. a purchase of, or an investment in, the securities issued by an affiliate of an IDI including a purchase of assets subject to an agreement to repurchase;[33]
3. an IDI's purchase of assets from an affiliate, except for purchases of real and personal property as may be specifically exempted by the Board by order or regulation;
4. the acceptance by an IDI of securities or other debt obligations issued by an affiliate as collateral security for a loan or extension of credit by the member bank to any person or company;[34]
5. the issuance by an IDI of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.
6. a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate; or
7. a derivative transaction, as defined in 12 U.S.C. 84(b), with an affiliate, to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate.

If a transaction between an IDI and an affiliate is not within one of the above categories, it is not a covered transaction for the purposes of section 23A and is not subject to its limitations. All covered transactions must be made on terms and conditions that are consistent with safe and sound banking practices.[35]

Among the transactions that generally are not subject to section 23A are dividends paid by an IDI to its holding company, sales of assets by an IDI to an affiliate for cash, an affiliate's purchase of securities issued by an IDI, and many service contracts between an IDI and an affiliate.[36] Certain classes of transactions between a member bank and an affiliate are discussed below as to whether they are covered transactions for purposes of section 23A. (See section 223.3(h).)

2020.1.4.1 Attribution Rule

The "attribution rule," found in section 223.16, prevents an IDI from evading its restrictions of

30. See 12 C.F.R. 225.31(d)(1)(i). The rule refers more generically to convertible "instruments." It clarifies that the convertibility presumption applies regardless of whether the right to convert resides in a financial instrument that technically qualifies as a "security" under section 23A or the federal securities laws.

31. See, for example, 12 C.F.R. 225.143 (Board Policy Statement on Equity Investments in Banks and Bank Holding Companies).

32. 12 U.S.C. 371c(b)(7).

33. The investment by an IDI or its affiliate in a financial subsidiary of the bank excludes the retained earnings of the financial subsidiary.

34. The acceptance of an affiliate's securities for a loan when proceeds are transferred to, or used for the benefit of, an affiliate is prohibited. (See section 223.3(h)(2).)

35. Board staff has taken the position that safety and soundness requires that the transaction be conducted on market terms.

36. A transaction when an IDI receives assets from an affiliate and the IDI pays a dividend or returns capital to an affiliate may result in a purchase of assets for the purposes of section 23A. Although these transactions are not subject to section 23A, they may be subject to section 23B or other laws.

section 23A by using intermediaries, and it limits the exposure that an IDI has to customers of affiliates of the IDI. Section 223.16 provides that any covered transaction by an IDI or its subsidiary with any person is deemed to be a transaction with an affiliate of the IDI if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. For example, an IDI's loan to a customer for the purpose of purchasing securities from the inventory of a broker-dealer affiliate of the member bank would be a covered transaction under section 23A.

2020.1.4.2 Credit Transactions with an Affiliate

2020.1.4.2.1 Extension of Credit to an Affiliate or Other Credit Transaction with an Affiliate

Section 23A includes a ''loan or extension of credit'' to an affiliate as a covered transaction, but does not define these terms. Section 223.3(o) of the rule defines ''extension of credit'' to an affiliate to mean the making or renewal of a loan to an affiliate, the granting of a line of credit to an affiliate, or the extending of credit to an affiliate in any manner whatsoever, including on an intraday basis. Transactions that are defined as extensions of credit include but are not limited to the following:

1. an advance to an affiliate by means of an overdraft, cash item, or otherwise;
2. a sale of federal funds to an affiliate;
3. a lease that is the functional equivalent of an extension of credit to an affiliate;[37]
4. an acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate;
5. any increase in the amount of, extension of the maturity of, or adjustment to the interest-rate term or other material term of, an extension of credit to an affiliate;[38] and
6. any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent) to an IDI.[39]

An IDI's purchase of a debt security issued by an affiliate is an extension of credit by the IDI to the affiliate for purposes of section 23A under the rule. An IDI that buys debt securities issued by an affiliate has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with the collateral requirements of section 23A. An exemption from the collateral requirements is provided for situations in which an IDI purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction.

2020.1.4.2.2 Valuation of Credit Transactions with an Affiliate

A credit transaction between an IDI and an affiliate initially must be valued at the amount of funds provided by the IDI to, or on behalf of, the affiliate plus any additional amount that the IDI could be required to provide to, or on behalf of, the affiliate. The section 23A value of a credit transaction between an IDI and an affiliate is the *greater of* (1) the principal amount of the credit transaction; (2) the amount owed by the affiliate to the member bank under the credit transaction; or (3) the sum of (a) the amount provided to, or on behalf of, the affiliate in the transaction and (b) any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the member transaction. (See 223.21)

The first prong of the rule's valuation formula for credit transactions (''the principal amount of the credit transaction'') would likely determine the valuation of a transaction in which an IDI purchased a zero-coupon note issued by an affiliate. An IDI should value such an extension of credit at the principal, or face amount of the note (that is, at the amount that the affiliate ultimately must pay to the IDI) rather than at the amount of funds initially advanced by the IDI. For example, assume an IDI purchased from an

37. The Board would consider a full-payout, net lease permissible for a national bank under 12 U.S.C. 24 (seventh) and 12 C.F.R. 23 to be the functional equivalent of an extension of credit.

38. A floating-rate loan does not become a new covered transaction whenever there is a change in the relevant index (for example, LIBOR or the member bank's prime rate) from which the loan's interest rate is calculated. If the member bank and the borrower, however, amend the loan agreement to change the interest-rate term from ''LIBOR plus 100 basis points'' to ''LIBOR plus 150 basis points,'' the parties have engaged in a new covered transaction.

39. The definition of extension of credit would cover, among other things, situations in which an affiliate fails to pay on a timely basis for services rendered to the affiliate by the IDI or the affiliate fails to pay a tax refund to the IDI.

affiliate for $50 a 10-year zero-coupon note issued by the affiliate with a face amount of $100. The rule's valuation formula requires the IDI to value this transaction at $100.

The second prong of the rule's valuation formula for credit transactions (''the amount owed by the affiliate'') likely would determine the valuation of a transaction in which an affiliate fails to pay an IDI when due a fee for services rendered by the IDI to the affiliate. This prong of the valuation formula does not include (within section 23A's quantitative limits) items such as accrued interest not yet due on an IDI's loan to an affiliate.

IDIs will be able to determine the section 23A value for most credit transactions under the third prong of the rule's valuation formula. Under this prong, for example, a $100 term loan is a $100 covered transaction, a $300 revolving credit facility is a $300 covered transaction (regardless of how much of the facility the affiliate has drawn down), and a guarantee backstopping a $500 debt issuance of the affiliate is a $500 covered transaction.

Under section 23A and the rule, a member bank has made an extension of credit to an affiliate if the IDI purchases from a third party a loan previously made to an affiliate of the IDI. A different valuation formula is provided for these indirect credit transactions: The IDI must value the transaction at the price paid by the IDI for the loan plus any additional amount that the IDI could be required to provide to, or on behalf of, the affiliate under the terms of the credit agreement.

For example, if an IDI pays a third party $90 for a $100 term loan that the third party previously made to an affiliate of the IDI (because, for example, the loan was at a fixed rate and has declined in value because of a rise in the general level of interest rates), the covered-transaction amount is $90 rather than $100. The lower covered-transaction amount reflects the fact that the IDI's maximum loss on the transaction is $90 rather than the original principal amount of the loan. For another example, if an IDI pays a third party $70 for a $100 line of credit to an affiliate, of which $70 had been drawn down by the affiliate, the covered-transaction amount would be $100 (the $70 purchase price paid by the IDI for the credit plus the remaining $30 that the IDI could be required to lend under the credit line).

In another example, an IDI makes a term loan to an affiliate that has a principal amount of $100. The affiliate pays $2 in up-front fees to the member bank, and the affiliate receives net loan proceeds of $98. The IDI must initially value the covered transaction at $100.

Although the rule considers an IDI's purchase of, or investment in, a debt security issued by an affiliate as an extension of credit to an affiliate, these transactions are not valued like other extensions of credit. See section 223.23 for the valuation rules for purchases of, and investments in, the debt securities of an affiliate.

2020.1.4.2.3 Timing of a Credit Transaction with an Affiliate

An IDI has entered into a credit transaction with an affiliate at the time during the day that the IDI becomes legally obligated to make the extension of credit to, or issue the guarantee, acceptance, or letter of credit on behalf of, the affiliate. A covered transaction occurs at the moment that the IDI executes a legally valid, binding, and enforceable credit agreement or guarantee and does not occur only when an IDI funds a credit facility or makes payment on a guarantee. Consistent with section 23A, the rule only requires an IDI to compute compliance with its quantitative limits when the IDI is about to engage in a new covered transaction. The rule does not require an IDI to compute compliance with the rule's quantitative limits on a continuous basis. See section 223.21(b)(1) of the rule.

The burden of the timing rule is mitigated significantly by the exemption for intraday extensions of credit found in section 223.42(l). The intraday credit exemption generally applies only to extensions of credit that an IDI expects to be repaid, sold, or terminated by the end of its U.S. business day. The IDI must have policies and procedures to manage and minimize the credit exposure. Any such extension of credit that is outstanding at the end of the IDI's business day must be treated as an extension of credit and must meet the regulatory quantitative and collateral requirements.

2020.1.4.2.4 Leases

Lease transactions that constitute the functional equivalent of a loan or an extension of credit may be subject to section 23A. Such lease arrangements, in effect, are equivalent to a loan by the IDI and are essentially financing arrangements. Some of the characteristics that would normally cause a lease to be construed as a loan equivalent include the lessee's having responsibility for the servicing, maintenance, insurance, licensing, or risk of loss or damage, and the lessee's having the option to purchase the equipment.

2020.1.4.2.5 Extensions of Credit Secured by Affiliate Securities—General Valuation Rule (Section 223.24(a) and (b))

Section 23A defines as a covered transaction an IDI's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company.[40] This type of covered transaction has two classes: one in which the only collateral for the loan is solely affiliate securities and another in which the loan is secured by a combination of affiliate securities and other collateral.[40a]

Under the rule, if the credit extension is secured exclusively by affiliate securities, then the transaction is valued at the full amount of the extension of credit. This approach reflects the difficulty of measuring the actual value of typically untraded and illiquid affiliate securities and conservatively assumes that the value of the securities is equal to the full value of the loan that the securities collateralize. An exception is provided to the general rule when the affiliate securities held as collateral have a ready market (as defined by section 223.42 of the rule). In that case, the transaction may be valued at the fair market value of the affiliate securities. The exception grants relief in those circumstances when the value of the affiliate securities is independently verifiable by reference to transactions occurring in a liquid market.[41]

Covered transactions of the second class, in which the credit extension is secured by affiliate securities and other collateral, are valued at the lesser of (1) the total value of the extension of credit minus the fair market value of the other collateral or (2) the fair market value of the affiliate securities (if the securities have a ready market). The rule's ready-market requirement applies regardless of the amount of affiliate collateral.[42]

2020.1.4.2.6 Extensions of Credit Secured by Affiliate Securities—Mutual Fund Shares

Section 23A(b)(7)(D) of the FRA defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company.

Section 223.24(c) of the rule provides an exemption for extensions of credit by a member bank that are secured by shares of an affiliated mutual fund. To qualify for the exemption, the transaction must meet several conditions. First, to ensure that the affiliate collateral is liquid and trades at a fair price, the affiliated mutual fund must be an open-end investment company that is registered with the SEC under the 1940 Act. Second, to ensure that the IDI can easily establish and monitor the value of the affiliate collateral, the affiliated mutual fund's shares serving as collateral for the extension of credit must have a publicly available market price. Third, to reduce the IDI's incentives to use these extensions of credit as a mechanism to support the affiliated mutual fund, the IDI and its affiliates must not own more than 5 percent of the fund's shares (excluding certain shares held in a fiduciary capacity). Finally, the proceeds of the extension of credit must not be used to purchase the affiliated mutual fund's shares serving as collateral or otherwise used to benefit an affiliate. In such circumstances, the IDI's extension of credit would be covered by section 23A's attribution rule. For example, an IDI proposes to lend $100 to a nonaffiliate secured exclusively by eligible affiliated mutual fund securities. The IDI knows that the nonaffiliate intends to use all the loan proceeds to purchase the eligible affiliated mutual fund securities that would serve as collateral for the loan. Under the attribution rule

40. See 12 U.S.C. 371c(b)(7)(D). This covered transaction only arises when the member bank's loan is to a nonaffiliate. Under section 23A, the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. (See 12 U.S.C. 371(c)(4)) If the proceeds of a loan that is secured by an affiliate's securities are transferred to an affiliate by the unaffiliated borrower (for example, to purchase assets or securities from the inventory of an affiliate), the loan should be treated as a loan to the affiliate and the affiliates securities cannot be used to meet the collateral requirements of sections 23A. The loan must then be secured with other collateral in an amount and of a type that meets the requirements of section 23A for loans by an IDI to an affiliate.

40a. The securities issued by an affiliate cannot be used as collateral for a loan to any affiliate (12 U.S.C. 371c (c)(4)).

41. In either case, the transaction must comply with section 23B; that is, the IDI must obtain the same amount of affiliate securities as collateral on the credit extension that the IDI would obtain if the collateral were not affiliate securities.

42. Under the rule, an IDI may use the higher of the two valuation options for these transactions if, for example, the IDI does not have the procedures and systems in place to verify the fair market value of affiliate securities.

in section 223.16, the IDI must treat the loan to the nonaffiliate as a loan to an affiliate, and because securities issued by an affiliate are ineligible collateral under section 223.14, the loan would not be in compliance with section 223.14.

2020.1.4.3 Asset Purchases

2020.1.4.3.1 Purchase of Assets under Regulation W

Regulation W provides that a purchase of assets by an IDI from an affiliate initially must be valued at the total amount of consideration given by the IDI in exchange for the asset. (See section 223.22.) This consideration can take any form and includes an assumption of liabilities by the IDI. An assumption of liabilities can include a mortgage, other debt obligations, or the cost associated with the transfer of employees, such as pension obligations, bonuses, or accrued vacation.

Asset purchases are a covered transaction for an IDI for as long as the IDI holds the asset. The value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with GAAP and are reflected on the IDI's financial statements.

Certain asset purchases by an IDI from an affiliate are *not* valued in accordance with the general asset-purchase valuation formula. First, if the IDI buys from one affiliate a loan made to a second affiliate, the IDI must value the transaction as a credit transaction with the second affiliate under section 223.21. Second, if the IDI buys from one affiliate a security issued by a second affiliate, the IDI must value the transaction as an investment in securities issued by the second affiliate under section 223.23. Third, if the IDI acquires the shares of an affiliate that becomes an operating subsidiary of the IDI after the acquisition, the IDI must value the transaction under section 223.31.

A special valuation rule applies to an IDI's purchase of a line of credit or loan commitment from an affiliate. An IDI initially must value such asset purchases at the purchase price paid by the IDI for the asset plus any additional amounts that the IDI is obligated to provide under the credit facility.[43] This special valuation rule ensures that there are limits on the amount of risk a company can shift to an affiliated IDI.

Section 23A(d)(6) provides an exemption for purchasing assets having a readily identifiable and publically available market quotation. Section 224.42(e) of the rule codified this exemption. Section 223.42(f) expands the statutory (d)(6) exemption to allow an IDI to purchase securities from an affiliate based on price quotes obtained from certain electronic screens so long as, among other things, (1) the selling affiliate is a broker-dealer registered with the SEC, (2) the securities are traded in a ready market and eligible for purchase by state IDIs, (3) the securities are not purchased within 30 days of an underwriting (if an affiliate of the IDI is an underwriter of the securities), and (4) the securities are not issued by an affiliate. See section 2020.1.10.2 for a further discussion of this exemption.

In contrast with credit transactions, an asset purchase from a nonaffiliate that later becomes an affiliate generally does not become a covered transaction for the purchasing IDI. However, if an IDI purchases assets from a nonaffiliate in contemplation that the nonaffiliate will become an affiliate of the IDI, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the IDI must ensure that the aggregate amount of the IDI's covered transactions (including any such asset purchase from the nonaffiliate) would not exceed the quantitative limits of section 23A at the time the nonaffiliate becomes an affiliate.

The following examples are provided to assist IDIs in valuing purchases of assets from an affiliate. An IDI's receipt of an encumbered asset from an affiliate ceases to be a covered transaction when, for example, the IDI sells the asset.

- *Cash purchase of assets.* An IDI purchases a pool of loans from an affiliate for $10 million. The IDI initially must value the covered transaction at $10 million. Going forward, if the borrowers repay $6 million of the principal amount of the loans, the IDI may value the covered transaction at $4 million.
- *Purchase of assets through an assumption of liabilities.* An affiliate of an IDI contributes

43. A member bank would not be required to include unfunded, but committed, amounts in the value of the covered transaction if (1) the credit facility being transferred from the affiliate to the bank is unconditionally cancelable (without cause) at any time by the IDI and (2) the IDI makes a separate credit decision before each drawing under the facility (see 12 C.F.R. 223.22).

real property with a fair market value of $200,000 to the IDI. The IDI pays the affiliate no cash for the property, but assumes a $50,000 mortgage on the property. The IDI has engaged in a covered transaction with the affiliate and initially must value the transaction at $50,000. Going forward, if the IDI retains the real property but pays off the mortgage, the IDI must continue to value the covered transaction at $50,000. If the IDI, however, sells the real property, the transaction ceases to be a covered transaction at the time of the sale (regardless of the status of the mortgage).

2020.1.4.3.2 IDI's Purchase of Securities Issued by an Affiliate

Section 23A includes as a covered transaction an IDI's purchase of, or investment in, securities issued by an affiliate. Section 223.23 of the rule requires an IDI to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary of the IDI) at the *greater* of the IDI's purchase price or carrying value of the securities. An IDI that paid no consideration in exchange for affiliate securities has to value the covered transaction at no less than the IDI's carrying value of the securities. In addition, if the IDI's carrying value of the affiliate securities increased or decreased after the IDI's initial investment (due to profits or losses at the affiliate), the amount of the IDI's covered transaction would increase or decrease to reflect the IDI's changing financial exposure to the affiliate. However, the amount of the IDI's covered transaction cannot decline below the amount paid by the IDI for the securities.

Several important considerations support the general carrying-value approach of this valuation rule. First, the approach would require an IDI to reflect its investment in securities issued by an affiliate at carrying value throughout the life of the investment, even if the IDI paid no consideration for the securities. Second, the approach is supported by the terms of the statute, which defines both a "purchase of" *and* an "investment in" securities issued by an affiliate as a covered transaction. The statute's "investment in" language indicates that Congress was concerned with an IDI's continuing exposure to an affiliate through an ongoing investment in the affiliate's securities.

Third, GLB Act amendments to section 23A supported the approach. The GLB Act defined a financial subsidiary of an IDI as an affiliate of the IDI, but specifically provides that the section 23A value of an IDI's investment in securities issued by a financial subsidiary did *not* include retained earnings of the subsidiary. The negative implication from this provision is that the section 23A value of an IDI's investment in *other* affiliates *includes* the affiliates' retained earnings, which would be reflected in the IDI's carrying value of the investment under the rule.

Finally, the carrying-value approach is consistent with the purposes of section 23A—imiting the financial exposure of IDIs to their affiliates and promoting safety and soundness. The valuation rule requires an IDI to revalue upwards the amount of an investment in affiliate securities only when the IDI's exposure to the affiliate increases (as reflected on the IDI's financial statements) and the IDI's capital increases to reflect the higher value of the investment. In these circumstances, the valuation rule merely reflects the IDI's greater financial exposure to the affiliate and enhances safety and soundness by reducing the IDI's ability to engage in additional transactions with an affiliate as the IDI's exposure to that affiliate increases.

The valuation rule also provides that the covered-transaction amount of an IDI's investment in affiliate securities can be no less than the purchase price paid by the IDI for the securities, even if the carrying value of the securities declines below the purchase price. This aspect of the valuation rule uses the IDI's purchase price for the securities as a floor for valuing the covered transaction. First, it ensures that the amount of the covered transaction never falls below the amount of funds actually transferred by the IDI to the affiliate in connection with the investment. In addition, the purchase-price floor limits the ability of an IDI to provide additional funding to an affiliate as the affiliate approaches insolvency. If investments in securities issued by an affiliate were valued strictly at carrying value, then the IDI could lend more funds to the affiliate as the affiliate's financial condition worsened. As the affiliate declined, the IDI's carrying value of the affiliate's securities would decline, the section 23A value of the IDI's investment likely would decline, and, consequently, the IDI would be able to provide additional funding to the affiliate under section 23A. This type of increasing support for an affiliate in distress is what section 23A was intended to restrict.

The following examples are designed to assist IDIs in valuing purchases of, and investments in, securities issued by an affiliate:

- *Purchase of the debt securities of an affiliate.* The parent holding company of an IDI owns 100 percent of the shares of a mortgage company. The IDI purchases debt securities issued by the mortgage company for $600. The initial carrying value of the securities is $600. The IDI initially must value the investment at $600.
- *Purchase of the shares of an affiliate.* The parent holding company of an IDI owns 51 percent of the shares of a mortgage company. The IDI purchases an additional 30 percent of the shares of the mortgage company from a third party for $100. The initial carrying value of the shares is $100. The IDI initially must value the investment at $100. Going forward, if the IDI's carrying value of the shares declines to $40, the IDI must continue to value the investment at $100.
- *Contribution of the shares of an affiliate.* The parent holding company of an IDI owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the IDI. The IDI gives no consideration in exchange for the shares. If the initial carrying value of the shares is $300, then the IDI initially must value the investment at $300. Going forward, if the IDI's carrying value of the shares increases to $500, the IDI must value the investment at $500.

2020.1.4.5 Issuance of a Letter of Credit or Guarantee

2020.1.4.5.1 Confirmation of a Letter of Credit Issued by an Affiliate

Section 23A includes as a covered transaction the issuance by an IDI of a letter of credit on behalf of an affiliate, including the confirmation of a letter of credit issued by an affiliate as a covered transaction. (See section 223.3(h)(5).) When an IDI confirms a letter of credit, it assumes the risk of the underlying transaction to the same extent as if it had issued the letter of credit.[44] Accordingly, a confirmation of a letter of credit issued by an affiliate is treated in the same fashion as an issuance of a letter of credit on behalf of an affiliate.

44. See UCC 5-107(2).

2020.1.4.5.2 Credit Enhancements Supporting a Securities Underwriting

The definition of guarantee in section 23A does not include an IDI's issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the IDI.[45] Such a credit enhancement would not be issued ''on behalf of'' the affiliate. Although the guarantee does provide some benefit to the affiliate (by facilitating the underwriting), this benefit is indirect. The proceeds of the guarantee would not be transferred to the affiliate for purposes of the attribution rule of section 23A.[46] Section 23B would apply to the transaction and, where an affiliate was issuer as well as underwriter, the transaction would be covered by section 23A because the credit enhancement would be on behalf of the affiliate.

2020.1.4.5.3 Cross-Guarantee Agreements and Cross-Affiliate Netting Arrangements

A cross-guarantee agreement among an IDI, an affiliate, and a nonaffiliate in which the nonaffiliate may use the IDI's assets to satisfy the obligations of a defaulting affiliate is a guarantee for purposes of section 23A. The cross-guarantee arrangements among IDIs and their affiliates are subject to the quantitative limits and collateral requirements of section 23A. (See section 223.3(h)(5).)

As for cross-affiliate netting arrangements (CANAs), such arrangements involve an IDI, one or more affiliates of the IDI, and one or more nonaffiliates of the IDI, where a nonaffiliate is permitted to deduct obligations of an affiliate of the IDI to the nonaffiliate when settling the nonaffiliate's obligations to the IDI. These arrangements also would include agreements in which an IDI is required or permitted to add the obligations of an affiliate of the IDI to a nonaffiliate when determining the IDI's obligations to the nonaffiliate. These types of CANAs expose an IDI to the credit risk of its affiliates because the IDI may become liable for the obligations of its affiliates. Because the exposure of an IDI to an affiliate in such an arrangement resembles closely the exposure of an IDI when it issues a guarantee on behalf of

45. See 62 *Fed. Reg.* 45295, August 27, 1997.
46. See 12 U.S.C. 371c(a)(2).

an affiliate, the rule explicitly includes such arrangements in the definition of covered transaction. Accordingly, the quantitative limits of section 23A would prohibit an IDI from entering into such a CANA to the extent that the netting arrangement does not cap the potential exposure of the IDI to the participating affiliate (or affiliates).

2020.1.4.5.4 Keepwell Agreements

In a keepwell agreement between an IDI and an affiliate, the IDI typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the IDI in entering into such a keepwell agreement is similar to the credit risk incurred by an IDI in connection with issuing a guarantee on behalf of an affiliate. As a consequence, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

2020.1.4.5.5 Prohibition on the Purchase of Low-Quality Assets

Section 23A generally prohibits the purchase by an IDI of a low-quality asset from an affiliate.[47] In addition, an IDI and its subsidiaries cannot purchase or accept as collateral a low-quality asset from an affiliate. Section 23A defines a low-quality asset to include (1) an asset classified as ‘‘substandard,’’ ‘‘doubtful,’’ or ‘‘loss,’’ or treated as ‘‘other loans specially mentioned,’’ in the most recent report of examination or inspection by a federal or state supervisory agency (a ‘‘classified asset‘‘), (2) an asset in nonaccrual status, (3) an asset on which payments are more than 30 days past due in the payment of principal or interest, or (4) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor. Any asset meeting one of the above four criteria, including securities and real property, is a low-quality asset.

Regulation W expands the definition of low-quality assets in several respects. (See 12 C.F.R. 223.3(v).) First an asset may be identified by examiners as a low-quality asset if they represent credits to countries that are not complying with their external debt-service obligations but are taking positive steps to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund Program. Although such assets may not be considered classified assets, examiners are to consider these assets in their assessment of an IDI’s asset quality and capital adequacy.

Second, the rule considers a financial institution’s use of its own internal asset-classification systems. The rule includes within the definition of low-quality asset not only assets classified during the last examination but also assets classified or treated as special mention under the institution’s internal classification system (or assets that received an internal rating that is substantially equivalent to classified or special mention in such an internal system).

The purchase by an IDI from an affiliate of assets that have been internally classified raises potentially significant safety-and-soundness concerns. The Board expects companies with internal rating systems to use the systems consistently over time and over similar classes of assets and will view as an evasion of section 23A any company’s deferral or alteration of an asset’s rating to facilitate sale of the asset to an affiliated institution.

Finally, the rule defines low-quality asset to include foreclosed property designated ‘‘other real estate owned’’ (OREO), until it is reviewed by an examiner and receives a favorable classification. It further defines as a low-quality asset any asset (not just real estate) that is acquired in satisfaction of a debt previously contracted (not just through foreclosure) if the asset has not yet been reviewed in an examination or inspection. Under the rule, if a particular asset is good collateral taken from a bad borrower, the asset should cease to be a low-quality asset upon examination.

Section 23A provides a limited exception to the general rule prohibiting purchase of low-quality assets if the IDI performs an independent credit evaluation and commits to the purchase of the asset before the affiliate acquires the asset.[48] Section 223.15 of the rule also provides an exception from the prohibition on the purchase by an IDI of a low-quality asset from an affiliate for certain loan renewals. The rule allows an IDI that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying

47. 12 U.S.C. 371c(a)(3). Section 23A does not prohibit an affiliate from donating a low-quality asset to a member bank, so long as the bank provides no consideration for the asset and no liabilities are associated with the asset.

48. 12 U.S.C. 371c(a)(3).

loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating IDI to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the IDI purchased its participation and (2) the proposed transaction would not increase the IDI's proportional share of the credit facility. The IDI must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20 days' post-consummation notice to its appropriate federal banking agency. An IDI is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the IDI's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the IDI (not just affiliated IDIs).

2020.1.5 COLLATERAL FOR CERTAIN TRANSACTIONS WITH AFFILIATES

Section 23A requires a member bank's use of collateral for certain transactions between an IDI and its affiliates.[49] Each loan or extension of credit to an affiliate,[50] or guarantee, acceptance, or letter of credit issued on behalf of an affiliate by an IDI or its subsidiary, and any credit exposure of an IDI or a subsidiary to an affiliate resulting from a securities borrowing or lending transaction, or a derivative transaction, shall be secured at all times by collateral ("credit exposure") at the amounts required by the statute. The required collateral varies,[51] depending on the type of collateral used to secure the transaction.[52] The specific collateral requirements are—

1. 100 percent of the amount of such loan or extension of credit, guarantee, acceptance, letter of credit or credit exposure, if the collateral is composed of—
   a. obligations of the United States or its agencies;
   b. obligations fully guaranteed by the United States or its agencies as to principal and interest;
   c. notes, drafts, bills of exchange, or banker's acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank;[53] or
   d. a segregated, earmarked deposit account with the member bank that is for the sole purpose of securing credit transactions between the member bank and its affiliates and is identified as such.
2. 110 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of obligations of any state or political subdivision of any state;
3. 120 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of other debt instruments, including receivables; or
4. 130 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of stock, leases, or other real or personal property.

For example, an IDI makes a $1,000 loan to an affiliate. The affiliate posts as collateral for the loan $500 in U.S. Treasury securities, $480 in corporate debt securities, and $130 in real estate. The loan satisfies the collateral requirements of section 23A because $500 of the loan is 100 percent secured by obligations of the United States, $400 of the loan is 120 percent secured by debt instruments, and $100 of the loan is 130 percent secured by real estate. The statute prohibits an IDI from counting a low-quality asset toward section 23A's collateral requirements for credit transactions with affiliates.[54] An IDI must maintain a perfected security interest at all times in the collateral that secures the credit transaction.

Each loan or extension of credit to an affiliate or guarantee, acceptance, credit exposure or letter of credit issued on behalf of an affiliate (herein referred to as credit transactions) by an IDI or its subsidiary must be secured at the time of the transaction by collateral.

49. The IDI must perfect the security interest in the collateral (*Fitzpatrick v. FDIC*, 765 F.2d 569 (6th Cir. 1985). A purchase of assets from an affiliate does not require collateral.
50. 12 U.S.C. 371c(b)(7).
51. "Credit extended" means the loan or extension of credit, guarantee, acceptance, or letter of credit.
52. 12 U.S.C. 371c(c)(1).
53. Regulation A includes a representative list of acceptable government obligations (12 C.F.R. 201.108).
54. 12 U.S.C. 371c(c)(3).

2020.1.5.1 Collateral Requirements in Regulation W

The collateral requirements for credit transactions are found in section 23A (c) of the statute. Section 23A (c)(1) requires that an IDI meet the collateral requirements of the statute at all times. A low-quality asset cannot be used to satisfy the statute's or regulation's collateral requirements, but can be taken as additional collateral.

2020.1.5.1.1 Deposit Account Collateral

Under section 23A, an IDI may satisfy the collateral requirements of the statute by securing a credit transaction with an affiliate with a "segregated, earmarked deposit account" maintained with the IDI in an amount equal to 100 percent of the credit extended.[55] IDIs may secure covered transactions with omnibus deposit accounts so long as the IDI takes steps to ensure that the omnibus deposit accounts fully secure the relevant covered transactions. Such steps might include substantial overcollateralization or the use of subaccounts or other recordkeeping devices to match deposits with covered transactions. To obtain full credit for any deposit accounts taken as section 23A collateral, IDIs must ensure that they have a perfected, first-priority security interest in the accounts. (See section 223.14(b)(1)(i)(D).)

2020.1.5.1.2 Ineligible Collateral

The purpose of section 23A's collateral requirements is to ensure that IDIs that engage in credit transactions with affiliates have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended.

The statute recognizes that certain types of assets are not appropriate to serve as collateral for credit transactions with an affiliate. In particular, the statute provides that low-quality assets and securities issued by an affiliate are not eligible collateral for such covered transactions.

Under section 223.14(c) of the rule, intangible assets also are not deemed acceptable to meet the collateral requirements imposed by section 23A.[56] Intangible assets, including servicing assets, are particularly hard to value, and an IDI may have significant difficulty in collecting and selling such assets in a reasonable period of time.

Section 23A(c) requires that credit transactions with an affiliate be "secured" by collateral. A credit transaction between an IDI and an affiliate supported only by a guarantee or letter of credit from a third party does not meet the statutory requirement that the credit transaction be secured by collateral. Guarantees and letters of credit often are subject to material adverse change clauses and other covenants that allow the issuer of the guarantee or letter of credit to deny coverage. Letters of credit and guarantees are not balance-sheet assets under GAAP and, accordingly, would not constitute "real or personal property" under section 23A. There is a particularly significant risk that an IDI may have difficulty collecting on a guarantee or letter of credit provided by a nonaffiliate on behalf of an affiliate of the IDI. Accordingly, guarantees and letters of credit are not acceptable section 23A collateral.

As noted above, section 23A prohibits an IDI from accepting securities issued by an affiliate as collateral for an extension of credit to any affiliate. The rule clarifies that securities issued by the IDI itself also are not eligible collateral to secure a credit transaction with an affiliate. Equity securities issued by a lending IDI, and debt securities issued by a lending IDI that count as regulatory capital of the IDI, are not eligible collateral under section 23A. If an IDI was forced to foreclose on a credit transaction with an affiliate secured by such securities, the IDI may be unwilling to liquidate the collateral promptly to recover on the credit transaction because the sale might depress the price of the IDI's outstanding securities or result in a change in control of the IDI. In addition, to the extent that an IDI is unable or unwilling to sell such securities acquired through foreclosure, the transaction would likely result in a reduction in the IDI's capital, thereby offsetting any potential benefit provided by the collateral.

2020.1.5.1.3 Perfection and Priority

Under section 223.14(d) of the rule, an IDI's security interest in any collateral required by section 23A must be perfected in accordance with applicable law to ensure that an IDI has

55. 12 U.S.C. 371c(c)(1)(A)(iv).

56. The rule does not confine the definition of intangible assets by reference to GAAP.

good access to the assets serving as collateral for its credit transactions with affiliates. This requirement ensures that the IDI has the legal right to realize on the collateral in the case of default, including a default resulting from the affiliate's insolvency or liquidation. An IDI also is required to either obtain a first-priority security interest in the required collateral or deduct from the amount of collateral obtained by the IDI the lesser of (1) the amount of any security interests in the collateral that are senior to that obtained by the IDI or (2) the amount of any credits secured by the collateral that are senior to that of the IDI. For example, if an IDI lends $100 to an affiliate and takes as collateral a second lien on a parcel of real estate worth $200, the arrangement would only satisfy the collateral requirements of section 23A if the affiliate owed the holder of the first lien $70 or less (a credit transaction secured by real estate must be secured at 130 percent of the amount of the transaction).

The rule includes the following example of how to compute the section 23A collateral value of a junior lien: An IDI makes a $2,000 loan to an affiliate. The affiliate grants the IDI a second-priority security interest in a piece of real estate valued at $3,000. Another institution that previously lent $1,000 to the affiliate has a first-priority security interest in the entire parcel of real estate. This transaction is not in compliance with the collateral requirements of this section. Because of the existence of the prior third-party lien on the real estate, the effective value of the real estate collateral for the IDI for purposes of this section is only $2,000—$600 less than the amount of real estate collateral required by this section for the transaction ($2,000 × 130 percent = $2,600).

2020.1.5.1.4 Unused Portion of an Extension of Credit

Section 23A requires that the "amount" of an extension of credit be secured by the statutorily prescribed levels of collateral. Under the statute, an IDI provides a line of credit to an affiliate, it must secure the full amount of the line of credit throughout the life of the credit. Section 223.14(f)(2) of the rule, however, provides an exemption to the collateral requirements of section 23A for the unused portion of an extension of credit to an affiliate so long as the IDI does not have any legal obligation to advance additional funds under the credit facility until the affiliate has posted the amount of collateral required by the statute with respect to the entire used portion of the extension of credit.[57] In such credit arrangements, securing the unused portion of the credit line is unnecessary from a safety-and-soundness perspective because the affiliate cannot require the IDI to advance additional funds without posting the additional collateral required by section 23A. If an IDI voluntarily advances additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire used amount (despite its lack of a legal obligation to make such an advance), the Board views this action as a violation of the collateral requirements of the statute. The entire amount of the line counts against the IDI's quantitative limit, even if the line of credit does not need to be secured.

2020.1.5.1.5 Purchasing Affiliate Debt Securities in the Secondary Market

An IDI's investment in the debt securities issued by an affiliate is an extension of credit by the IDI to the affiliate and thus is subject to section 23A's collateral requirements. Section 223.14(f)(3) of the rule provides an exemption that permits IDIs in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. The exemption is available where an IDI purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction. When an IDI buys an affiliate's debt securities in a bona fide secondary-market transaction, the risk that the purchase is designed to shore up an ailing affiliate is reduced. Any purchase of affiliate debt securities that qualifies for this exemption would still remain subject to the quantitative limits of section 23A and the market-terms requirement of section 23B. In analyzing an IDI's good faith under this exemption transaction, examiners should look at (1) the time elapsed between the original issuance of the affiliate's debt securities and the IDI's purchase, (2) the existence of any relevant agreements or relationships between the IDI and the third-party seller of the affiliate's debt securities, (3) any history of IDI

57. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception. Moreover, these transactions are still subject to the 10 and 20 percent limits of the statute.

financing of the affiliate, and (4) any other relevant information.

2020.1.5.1.6 Credit Transactions with Nonaffiliates that Become Affiliates

IDIs sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the IDI. Section 223.21(b)(2) provides transition rules that exempt credit transactions from the collateral requirements in situations in which the IDI entered into the transactions with the nonaffiliate at least one year before the nonaffiliate became an affiliate of the IDI. For example, an IDI with capital stock and surplus of $1,000 and no outstanding covered transactions makes a $120 unsecured loan to a nonaffiliate. The IDI does not make the loan in contemplation of the nonaffiliate becoming an affiliate. Nine months later, the bank holding company purchases all the stock of the nonaffiliate, thereby making the nonaffiliate an affiliate of the IDI. The IDI is not in violation of the quantitative limits of the rule's section 223.11 or 223.12 at the time of the stock acquisition. The IDI is, however, prohibited from engaging in any additional covered transactions with the new affiliate at least until such time as the value of the loan transaction falls below 10 percent of the IDI's capital stock and surplus, and the transaction counts toward the 20 percent limit for transactions with all affiliates. In addition, the IDI must bring the loan into compliance with the collateral requirements of section 223.14 promptly after the stock acquisition. Transactions with nonaffiliates in contemplation of the nonaffiliate becoming an affiliate must meet the quantitative and collateral requirements of the rule at the time of the inception of the credit transaction and of the affiliation.

2020.1.6 LIMITATIONS ON COLLATERAL

IDIs may accept as collateral for covered transactions receivables, leases, or other real or personal property.[58] The following are limitations and collateral restrictions:

1. Any collateral that is subsequently retired or amortized must be replaced by additional eligible collateral. This is done to keep the percentage of the collateral value relative to the amount of the outstanding loan or extension of credit, guarantee, acceptance, or letter of credit equal to the minimum percentage that was required at the inception of the transaction.
2. A low-quality asset is not acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, an affiliate, or credit exposure to an affiliate resulting from a securities borrowing or lending transaction, or derivative transaction.
3. Securities or other debt obligations issued by an affiliate of an IDI shall not be acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, or credit exposure from a securities borrowing or lending transaction, or derivative transaction to, that affiliate or any other affiliate of the IDI.

The above collateral requirements are not applicable to an acceptance that is already fully secured either by attached documents or by other property that is involved in the transaction and has an ascertainable market value.

2020.1.7 DERIVATIVE TRANSACTIONS WITH AFFILIATES

2020.1.7.1 Derivative Transactions between Insured Depository Institutions and Their Affiliates

Derivative transactions between an IDI and its affiliates generally arise from the risk-management needs of the institution or the affiliate. Transactions arising from the institution's needs typically occur when an institution enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract, or when the institution is unable to hedge the risk directly because it is not authorized to hold the hedging asset. To manage the market risk, the institution may have an affiliate acquire the hedging asset. The institution would then do a bridging derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between an IDI and its affiliate are affiliate-driven. To accomplish its asset-liability-management goals, an

58. As noted above, letters of credit and mortgage-servicing rights may not be accepted as collateral for purposes of section 23A. See section 223.14(c)(4)(5) of the rule (12 C.F.R. 223.14(c)(4) and (5).

institution's affiliate may enter into an interest-rate or foreign-exchange derivative with the institution. For example, an institution's holding company may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The holding company may then enter into a fixed-to-floating interest-rate swap with its subsidiary member bank to reduce the holding company's interest-rate risk.

IDIs and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. IDIs and their affiliates often choose to use each other as their derivative counterparties, however, to maximize the profits of, and manage risks within, the consolidated financial group.

2020.1.7.1.1 Section 23A on Derivatives Transactions

The Dodd-Frank Act amended section 23A as it relates to derivatives and now provides that a derivative transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes (12 U.S.C. 84(b)) with an affiliate, is a covered transaction to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate. The Dodd-Frank Act also requires that any credit exposure must be secured consistent with the collateral requirements of section 23A. This is a significant change and requires that all IDIs calculate the relevant credit exposure and count that amount towards the institution's quantitative limits. The Dodd-Frank Act requires the IDI to establish and maintain policies and procedures designed to manage the credit exposure arising from the derivative. These policies and procedures require, at a minimum, that the institution monitor and control its exposure to its affiliates by imposing appropriate credit controls and collateral requirements. Regulation W provides that credit derivatives between an institution and an unaffiliated third party that reference the obligations of an affiliate of the institution and that are the functional equivalent of a guarantee by the institution on behalf of an affiliate should be treated as a guarantee by the institution on behalf of an affiliate for the purposes of section 23A. (The novation of a derivative between an IDI and its affiliate is treated as a purchase under the statute.)

2020.1.7.1.2 Section 23B and Regulation W Regarding Derivative Transactions

Derivative transactions between an IDI and an affiliate also are subject to section 23B of the FRA under the express terms of the statute.[59]

Regulation W clarifies further that the transactions are subject to the market-terms requirement of section 23B of the FRA (see section 223.51). The rule requires IDIs to comply strictly with section 23B in their derivative transactions with affiliates. Section 23B requires an institution to treat an affiliate no better than a *similarly situated* nonaffiliate. To comply with section 23B of the FRA, each institution should have in place credit limits on its derivatives exposure to affiliates that are at least as strict as the credit limits the institution imposes on unaffiliated companies that are engaged in similar businesses and are substantially equivalent in size and credit quality. Similarly, each institution should monitor derivatives exposure to affiliates at least as rigorously as it monitors derivatives exposure to comparable unaffiliated companies. In addition, each institution should price and require collateral in its derivative transactions with affiliates in a way that is at least as favorable to the institution as the way in which it would price or require collateral in a derivative transaction with comparable unaffiliated counterparties.

Section 23B generally does not allow an IDI to use with an affiliate the terms and conditions it uses with its most creditworthy unaffiliated customer unless the institution can demonstrate that the affiliate is of comparable creditworthiness as its most creditworthy unaffiliated customer. Instead, section 23B requires that an affiliate be treated comparably (with respect to terms, conditions, and credit limits) to the majority of third-party customers engaged in the same business, and having comparable credit quality and size as the affiliate. Because an IDI generally has the strongest credit rating within a holding company, the Board generally would not expect an affiliate to obtain better terms and

59. In addition to applying to covered transactions, as defined in section 23A of the FRA, the market-terms requirement of section 23B of the FRA applies broadly to, among other things, "[t]he payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise" (12 U.S.C. 371c-1(a)(2)(C)). Institution-affiliate derivatives generally involve a contract or agreement to pay money to the affiliate or furnish risk-management services to the affiliate.

conditions from an IDI than the institution receives from its major unaffiliated counterparties. In addition, market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a relatively small exposure threshold.

2020.1.7.1.3 Covering Derivatives That Are the Functional Equivalent of a Guarantee

Although most derivatives are not treated as covered transactions, section 223.33 of the rule provides that credit derivatives between an IDI and a nonaffiliate in which the IDI protects the nonaffiliate from a default on, or a decline in the value of, an obligation of an affiliate of the IDI are covered transactions under section 23A. Such derivative transactions are viewed as guarantees by a member bank on behalf of an affiliate (and, hence, are covered transactions) under section 23A.

The rule provides that these credit derivatives are covered transactions under section 23A and gives several examples.[60] An IDI is not allowed to reduce its covered transaction amount for these derivatives to reflect hedging positions established by the IDI with third parties. A credit derivative is treated as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the IDI.

2020.1.8 INTRADAY EXTENSIONS OF CREDIT

An extension of credit under section 23A of the FRA includes the credit exposure arising from intraday extensions of credit by IDIs to their affiliates. IDIs regularly provide transaction accounts to their affiliates in conjunction with providing payment and securities clearing services. As in the case of unaffiliated commercial customers, these accounts are occasionally subject to overdrafts during the day that are repaid in the ordinary course of business.

Intraday extensions of credit by an IDI to an affiliate are subject to the market-terms requirement of section 23B under the rule. The rule also requires that, under section 23A, institutions establish and maintain policies and procedures that are reasonably designed to manage the credit exposure arising from an institution's intraday extensions of credit to affiliates. The policies and procedures must, at a minimum, provide for monitoring and controlling the institution's intraday credit exposure to each affiliate, and to all affiliates in the aggregate, and ensure that the institution's intraday credit extensions to affiliates comply with section 23B.

Section 223.42(l) of the rule provides that intraday credit extensions by an IDI to an affiliate are section 23A covered transactions but exempts all such intraday credit extensions from the quantitative and collateral requirements of section 23A if the IDI (1) maintains policies and procedures for the management of intraday credit exposure and (2) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms. The policies and procedures are to be established and maintained for—

1. monitoring and controlling the credit exposure arising at any one time from the IDI's intraday extensions of credit to each affiliate and all affiliates in the aggregate and
2. ensuring that any intraday extensions of credit by the IDI to an affiliate comply with the market-terms requirement of section 223.51 of the rule.

2020.1.8.1 Standard under Which the Agencies May Grant Additional Exemptions

The Dodd-Frank Act amended section 23A to authorize the appropriate federal banking agency to exempt transactions or relationships by order if the exemption would be in the public interest and consistent with the purposes of section 23A. The exemption determination requires the concurrence of the Board. The FDIC has a 60-day period to determine whether the requested exemption presents an unacceptable risk to the insurance fund. The request should describe in detail the transaction or relationship for which the member bank seeks exemption. The exemption request also should explain why the Agency should exempt the transaction or relationship, and why it meets the public interest standard of the statute. The Board has approved a number of exemptions, most of

60. In most instances, the covered-transaction amount for such a credit derivative would be the notional principal amount of the derivative.

which involve corporate reorganizations. These exemptions are available on the Board's website, www.federalreserve.gov/boarddocs/legalint/FederalReserve Act.

2020.1.9 EXEMPTIONS FROM SECTION 23A

Section 23A exempts seven transactions or relations from its quantitative limits and collateral requirements.[61] Regulation W, subpart E, clarifies these exemptions and exempts a number of additional types of transactions. The Board reserves the right to revoke or modify any additional exemption granted by the Board in Regulation W, if the Board finds that the exemption is resulting in unsafe or unsound banking practices. The Board also reserves the right to terminate the eligibility of a particular IDI to use any such exemption if the IDI's use of the exemption is resulting in unsafe or unsound banking practices.

2020.1.9.1 Covered Transactions Exempt from the Quantitative Limits and Collateral Requirements

Under the rule's section 223.41, the quantitative limits (sections 223.11 and 223.12) and the collateral requirements (section 223.14) do not apply to the following transactions. The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and the prohibition on the purchase of a low-quality asset (section 223.15).

2020.1.9.1.1 Parent Institution/Subsidiary Institution Transactions

Transactions with an IDI are exempt from the quantitative limits and collateral requirements (section 223.14) if the member bank controls 80 percent or more of the voting securities of the IDI or the depository institution controls 80 percent or more of the voting securities of the IDI.

2020.1.9.1.2 Sister-Bank Exemption (section 223.41(b))

Regulation W exempts transactions with an IDI if the same company controls 80 percent or more of the voting securities of the member bank and the IDI.[62] In addition, the statute provides that covered transactions between sister banks must be consistent with safe and sound banking practices.[63]

The sister-bank exemption generally applies only to transactions between IDIs.[64] The rule's definition of affiliate excludes uninsured depository institution subsidiaries of a member bank. Covered transactions between a member bank and a parent uninsured depository institution or a commonly controlled uninsured depository institution, under the rule, generally would be subject to section 23A, whereas covered transactions between a member bank and a subsidiary uninsured depository institution would not be subject to section 23A.[65]

The sister-bank exemption, by its terms, only exempts transactions by a member bank with a sister-bank affiliate; hence, the sister-bank exemption cannot exempt a member bank's extension of credit or other covered transaction to an affiliate that is not a sister bank (even if the extension of credit was purchased from a sister bank). For example, an IDI purchases from Sister-Bank Affiliate A a loan to Affiliate B in a purchase that qualifies for the sister-bank exemption in section 23A. The IDI's asset purchase from Sister-Bank Affiliate A would be an exempt covered transaction under section 223.41(b), but the member bank also would have acquired an extension of credit to Affiliate B, which would be a covered transaction between the IDI and Affiliate B under section 223.3(h)(1) that does not qualify for the sister-bank exemption.

61. See 12 U.S.C. 371c(d)

62. Banks that are affiliated in this manner are referred to as "sister banks." Sister banks can improve their efficiency through intercorporate transfers under this exception. Also, "company" in this context is not limited to a bank holding company. For example, if a retail corporation owns two credit card banks, the two credit card banks would be sister banks, and the sister-bank exception could be used for transactions between two credit card banks.

63. 12 U.S.C. 371c(a)(4).

64. A member bank and its operating subsidiaries are considered a single unit for purposes of section 23A. Under the statute and the regulation, transactions between a member bank (or its operating subsidiary) and the operating subsidiary of a sister-insured depository institution generally qualify for the sister-bank exemption.

65. The sister-bank exemption in section 23A does not allow a member bank to avoid any restrictions on sister-bank transactions that may apply to the bank under the prompt corrective-action framework set forth in section 38 of the FDI Act (12 U.S.C. 1831o) and regulations adopted by the bank's appropriate federal banking agency.

2020.1.9.1.3 Purchase of Loans on a Nonrecourse Basis from an Affiliated IDI

Banks that are commonly controlled (i.e., at least 25 percent common ownership) can purchase loans on a nonrecourse basis. This allows chain banks and banks in companies that are not owned 80 percent by the same company to achieve the same efficiency as sister banks. The exemption only applies to the purchase of loans; other covered transactions, such as extensions of credit, are not exempt.

2020.1.9.1.4 Internal Corporate Reorganizations

Section 223.41(d) of the rule provides an exemption for asset purchases by an IDI from an affiliate that is part of a one-time internal corporate reorganization of a holding company.[66] The exemption includes purchases of assets in connection with a transfer of securities issued by an affiliate to an IDI, as described in section 223.31(a).

Under this exemption, an IDI would be permitted to purchase assets (other than low-quality assets) from an affiliate (including in connection with an affiliate share transfer that section 223.31 of the rule treats as a purchase of assets) that are exempt from the quantitative limits of section 23A if the following conditions are met.

First, the purchase must be part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate. The asset purchase must not be part of a series of periodic, ordinary-course asset transfers from an affiliate to an IDI.[67] Second, the IDI's holding company must provide the Board with contemporaneous notice of the transaction and must commit to the Board to make the IDI whole, for a period of two years, for any transferred assets that become low-quality assets.[68] Third, a majority of the IDI's directors must review and approve the transaction before consummation. Fourth, the section 23A value of the covered transaction must be less than 10 percent of the IDI's capital stock and surplus (or up to 25 percent of the IDI's capital stock and surplus with the prior approval of the appropriate federal banking agency) for the IDI. Fifth, the holding company and all its subsidiary depository institutions must be well capitalized and well managed and must remain well capitalized upon consummation of the transaction.

2020.1.9.2 Other Covered Transactions Exempt from the Quantitative Limits, Collateral Requirements, and Low-Quality-Asset Prohibition

The quantitative limits (sections 223.11 and 223.12), the collateral requirements (section 223.14), and the prohibition on the purchase of a low-quality asset (section 223.15) do not apply to the following exempted transactions (see section 223.42) and certain conditions. The transactions are, however, subject to the safety-and-soundness requirement (section 223.13). Detailed conditions or restrictions pertaining to these exemptions are discussed after this list.

1. Making correspondent banking deposits in an affiliated depository institution (as defined in section 3 of the FDI Act (12 U.S.C. 1813) or in an affiliated foreign bank that represents an ongoing, working balance maintained in the ordinary course of correspondent business
2. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business

66. See 1998 *Fed. Res. Bull.* 985 and 1013-14.

67. The IDI must provide the Board, as well as the appropriate federal agency, a notice that describes the primary business activities of the affiliate whose shares or assets are being transferred to the IDI and must indicate the anticipated date of the reorganization.

68. The holding company can meet these criteria by either repurchasing the assets at book value plus any write-down that has been taken or by making a quarterly cash contribution to the bank equal to the book value plus any write-downs that have been taken by the bank. The purchase or payment must be made within 30 days of each quarter end. In addition, if a cash payment is made, the IDI will hold an amount of risk-based capital equal to the book value of any transferred assets that become low-quality so long as the IDI retains ownership or control of the transferred asset. For example, under this dollar-for-dollar capital requirement, the risk-based capital charge for each transferred low-quality loan asset would be 100 percent (equivalent to a 1250 percent risk weight), rather than the 8 percent requirement (equivalent to a 100 percent risk weight) that would apply to a similar defaulted loan asset that is not a part of the transferred asset pool. See the Board's letter dated December 21, 2007, to Andres L. Navarette (Capital One Financial Corp.). Once the capital pool has been allocated to specific assets as described above, the capital cannot be applied to other low-quality assets if the initial low-quality asset returns to performing status. The IDI can only apply the allocated capital pool to new assets if the initial assets are fully paid or sold.

3. Transactions secured by cash or U. S. government securities
4. Purchasing securities of a servicing affiliate, as defined by section 4(c)(1) of the BHC Act
5. Purchasing certain liquid assets
6. Purchasing certain marketable securities
7. Purchasing certain municipal securities
8. Purchasing from an affiliate an extension of credit subject to a repurchase agreement that was originated by an IDI and sold to the affiliate subject to a repurchase agreement or with recourse
9. Asset purchases from an affiliate by a newly formed IDI, if the appropriate federal banking agency for the IDI has approved the asset purchase in writing in connection with the review of the formation of the IDI
10. Transactions approved under the Bank Merger Act that involve affiliated IDIs or an IDI and the U.S. branches and agencies of a foreign bank
11. Purchasing, on a nonrecourse basis, an extension of credit from an affiliate under certain conditions
12. Intraday extensions of credit
13. Riskless-principal transactions

2020.1.9.2.1 Correspondent Banking

Section 23A exempts from its quantitative limits and collateral requirements a deposit by an IDI in an affiliated IDI or affiliated foreign bank that is made in the ordinary course of correspondent business, subject to any restrictions that the Board may impose.[69] Section 223.42(a) of the rule further provides that such deposits must represent ongoing, working balances maintained by the IDI in the ordinary course of conducting the correspondent business.[70] Although not specified by section 23A or the Home Owners' Loan Act (HOLA), the rule also provides that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

2020.1.9.2.2 Secured Credit Transactions

Section 23A and section 223.42(c) of the rule exempt any credit transaction by an IDI with an affiliate that is "fully secured" by obligations of the United States or its agencies, or obligations that are fully guaranteed by the United States or its agencies, as to principal and interest.[71]

A deposit account meets the "segregated, earmarked" requirement only if the account exists for the sole purpose of securing credit transactions between the member bank and its affiliates and is so identified. Under section 23A, if U.S. government obligations or deposit accounts are sufficient to fully secure a credit transaction, then the transaction is completely exempt from the quantitative limits of the statute. If, however, the U.S. government obligations or deposit accounts represent less than full security for the credit transaction, then the amount of U.S. government obligations or deposits counts toward the collateral requirements of section 23A, but no part of the transaction is exempt from the statute's quantitative limits.

The exemption provides that a credit transaction with an affiliate will be exempt "to the extent that the transaction is and remains secured" by appropriate (d)(4) collateral. If an IDI makes a $100 nonamortizing term loan to an affiliate that is secured by $50 of U.S. Treasury securities and $75 of real estate, the value of the covered transaction will be $50. If the market value of the U.S. Treasury securities falls to $45 during the life of the loan, the value of the covered transaction would increase to $55. The Board expects IDIs that use this expanded (d)(4) exemption to review the market value of their U.S. government obligations collateral regularly to ensure compliance with the exemption.

2020.1.10 ASSET PURCHASES FROM AN AFFILIATE—EXEMPTIONS

2020.1.10.1 Purchase of a Security by an Insured Depository Institution from an Affiliate

Section 23A of the FRA restricts the ability of a member bank to fund its affiliates through asset purchases, loans, or certain other transactions (referred to as "covered transactions").

69. 12 U.S.C. 371c(d)(2).

70. Unlike the sister-bank exemption, the exemption for correspondent banking deposits applies to deposits placed by a member bank in an *uninsured* depository institution or foreign bank.

71. 12 U.S.C. 371c(d)(4). A partial list of such obligations can be found in the rules's section 201.108 (12 C.F.R. 201.108).

Paragraph (d)(6) of section 23A contains an exemption from the statute (the (d)(6) exemption) for "purchasing assets having a readily identifiable and publicly available market quotation," if the purchase is at or below such quotation.[72]

2020.1.10.2 Purchases of Assets with Readily Identifiable Market Quotes

Section 23A(d)(6) exempts the purchase of assets by an IDI from an affiliate if the assets have a "readily identifiable and publicly available market quotation" and are purchased at their current market quotation. The rule (section 223.42(e)) limits the availability of this exemption (the (d)(6) exemption) to purchases of assets with market prices that are recorded in widely disseminated publications that are readily available to the general public, such as newspapers with a national circulation. Because as a general matter only exchange-traded assets are recorded in such publications, this test has ensured that the qualifying assets are traded actively enough to have a true "market quotation" and that examiners can verify that the assets are purchased at their current market quotation. The rule applies if the asset is purchased at or below the asset's current market quotation.[73]

The (d)(6) exemption may apply to a purchase of assets that are not traded on an exchange. In particular, purchases of foreign exchange, gold, and silver, and purchases of over-the-counter (OTC) securities and derivative contracts whose prices are recorded in widely disseminated publications, may qualify for the (d)(6) exemption.

If an IDI purchases from one affiliate, the securities issued by another affiliate, the IDI has engaged in two types of covered transactions: (1) the purchase of securities from an affiliate and (2) the investment in securities issued by an affiliate. Under the rule, although the (d)(6) exemption may exempt the one-time asset purchase from the first affiliate, it would not exempt the ongoing investment in securities being issued by a second affiliate.

72. 12 U.S.C. 371c(d)(6).

73. The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation's price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at a publicly available market quotation.

2020.1.10.3 Purchasing Certain Marketable Securities

Regulation W provided an additional exemption from section 23A for certain purchases of securities by a member bank from an affiliate. The rule expanded the statutory (d)(6) exemption to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic services so long as, among other things, the selling affiliate is a broker-dealer registered with the SEC, the securities have a ready market and are eligible for purchase by state member banks, the securities are not purchased within 30 days of an underwriting (if an affiliate of the bank is an underwriter of the securities), and the securities are not issued by an affiliate.

2020.1.10.3.1 Broker-Dealer Requirement and Securities Purchases from Foreign Broker-Dealers

Under the Regulation W exemption, the selling affiliate must be a broker-dealer securities affiliate that is registered with the Securities and Exchange Commission (SEC). Broker-dealers that are registered with the SEC are subject to supervision and examination by the SEC and are required by SEC regulations to keep and maintain detailed records concerning each securities transaction conducted by the broker-dealer. In addition, SEC-registered broker-dealers have experience in determining whether a security has a "ready market" under SEC regulations. The rule does not expand the exemption to include securities purchases from foreign broker-dealers. The rule explicitly provides, however, that an IDI may request that the Board exempt securities purchases from a particular foreign broker-dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.

2020.1.10.3.2 Securities Eligible for Purchase by a State Member Bank

The exemption requires that the IDI's purchase of securities be eligible for purchase by a state member bank. For example, the Board determined that a member bank may purchase equity securities from an affiliate, if the purchase is made to hedge the member bank's permissible customer-driven equity derivative transaction. The purchase must be treated as a purchase of a security on the Call Report.

2020.1.10.3.3 No Purchases Within 30 Days of an Underwriting

The exemption generally prohibits an IDI from using the exemption to purchase securities during an underwriting, or within 30 days of an underwriting, if an affiliate of the IDI is an underwriter of the securities. This provision applies unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies. The rule includes the 30-day requirement because of the uncertain and volatile market values of securities during and shortly after an underwriting period and because of the conflicts of interest that may arise during and after an underwriting period, especially if an affiliate has difficulty selling its allotment.

2020.1.10.3.4 No Securities Issued by an Affiliate

If an IDI purchases from one affiliate securities issued by another affiliate, it would not exempt the investment in securities issued by the second affiliate, even though the exemption may exempt the asset purchase from the first affiliate. The transaction would be treated as a purchase of, or an investment in, securities issued by an affiliate.

2020.1.10.3.5 Price-Verification Methods

The exemption applies only in situations in which the IDI is able to obtain price quotes on the purchased securities from an unaffiliated electronic, real-time pricing service. The Board reaffirmed its position that it would not be appropriate to use independent dealer quotations or economic models to establish a market price for a security under the (d)(6) exemption. A security that is not quoted routinely in a widely disseminated news source or a third-party electronic financial network may not trade in a sufficiently liquid market to justify allowing an IDI to purchase unlimited amounts of the security from an affiliate.

2020.1.10.3.6 Record Retention

The rule expressly includes a two-year record-retention and supporting information requirement that is sufficient to enable the appropriate federal banking agencies to ensure that the IDI is in compliance with the terms of the exemption.

2020.1.10.4 Purchasing Municipal Securities

Section 223.42(g) of the rule exempts an IDI's purchase of municipal securities from an affiliate if the purchase meets certain requirements.[74] First, the IDI must purchase the municipal securities from a broker-dealer affiliate that is registered with the SEC. Second, the municipal securities must be eligible for purchase by a state member bank, and the IDI must report the transaction as a securities purchase in its Call Report. Third, the municipal securities should either be rated by a nationally recognized statistical rating organization (NRSRO) or be part of an issue of securities that does not exceed $25 million in size. Finally, the price for the securities purchased must be (1) quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks; (2) verified by reference to two or more actual independent dealer quotes on the securities to be purchased or securities that are comparable to the securities to be purchased; or (3) in the case of securities purchased during the underwriting period, verified by reference to the price indicated in the syndicate manager's written summary of the underwriting.[75] Under any of the three pricing options, the IDI must purchase the municipal securities at or below the quoted or verified price.

74. Municipal securities are defined by reference to section 3(a)(29) of the Securities Exchange Act. That Act defines municipal securities as direct obligations of, or obligations guaranteed as to principal or interest by, a state or agency, instrumentality, or political subdivision thereof, and certain tax-exempt industrial development bonds. (See 17 U.S.C. 78c(a)(29).)

75. Under the Municipal Securities Rulemaking Board's Rule G-11, the syndicate manager for a municipal bond underwriting is required to send a written summary to all members of the syndicate. The summary discloses the aggregate par values and prices of bonds sold from the syndicate account.

2020.1.10.5 Purchase of Loans on a Nonrecourse Basis

Section 223.41(c) of the rule exempts the purchase of loans on a nonrecourse basis from an affiliated depository institution. Under sections 23A(d)(6), a member bank may purchase loans on a nonrecourse basis from an affiliated "bank" exempt from the quantitative limitations of section 23A, even if the transactions does not qualify for the sister-bank exemption.[76] The rule clarifies that the scope of the exemption parallels that of the sister-bank exemption by stating that this exemption applies only to a member bank's purchase of a loan from an affiliated IDI.

2020.1.10.6 Purchases of Assets by Newly Formed Institutions

Section 223.42(i) of the rule exempts a purchase of assets by a newly formed IDI from an affiliate if the appropriate federal banking agency for the IDI has approved the purchase. This exemption allows companies to charter a new IDI and to transfer assets to the IDI free of the quantitative limits and low-quality-asset prohibition of section 23A.

2020.1.10.7 Transactions Approved under the Bank Merger Act

The Bank Merger Act exemption applies to transactions between an IDI and a certain IDI affiliate. Section 223.42(j) exempts transactions between IDIs that are approved pursuant to the Bank Merger Act. The rule also makes the Bank Merger Act exemption available for merger and other related transactions between an IDI and a U.S. branch or agency of an affiliated foreign bank, if the transaction has been approved by the responsible federal banking agency pursuant to the Bank Merger Act. There is no regulatory exemption for merger transactions between an IDI and its nonbank affiliate. Any IDI merging or consolidating with a nonbank affiliate may be able to take advantage of the regulatory exemption for internal-reorganization transactions contained in section 223.41(d) of the rule.

76. See 12 U.S.C. 371c(d)(6).

2020.1.11 PURCHASES OF EXTENSIONS OF CREDIT—THE PURCHASE EXEMPTION

Regulation W codified, with changes, the exemption that was previously found at section 250.250 (12 C.F.R. 250.250). In general,

1. The purchase of an extension of credit on a nonrecourse basis from an affiliate is exempt from section 23A's quantitative limits provided that—
   a. the extension of credit is originated by the affiliate;
   b. the IDI makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit;
   c. the IDI commits to purchase the extensions of credit before the affiliate makes or commits to the extensions of credit; and
   d. the IDI does not make a blanket advance commitment to purchase extensions of credit from the affiliate. (See section 223.42(k) of the rule.)
2. The rule also includes a 50 percent limit on the amount of loans an IDI may purchase from an affiliate under the purchase exemption. When an IDI purchases more than half of the extensions of credit originated by an affiliate, the purchases represent the principal ongoing funding mechanism for the affiliate. The IDI's status as the predominant source of financing for the affiliate calls into question the availability of alternative funding sources for the affiliate, places significant pressure on the IDI to continue to support the affiliate through asset purchases, and reduces the IDI's ability to make independent credit decisions with respect to the asset purchases.
3. *"Substantial, ongoing funding" test.* The rule allows the appropriate federal banking agency for an IDI to reduce the 50 percent threshold prospectively, on a case-by-case basis, in those situations in which the agency believes that the IDI's asset purchases from an affiliate under the exemption may cause harm to the IDI.
4. *Independent credit review by the IDI.* To qualify for the purchase exemption under section 223.42(k), an IDI must independently review the creditworthiness of the borrower before committing to purchase each loan. Under established Federal Reserve guidance, an IDI is required to have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the

credit and other risks inherent in a proposed transaction.[77] This function is not delegable to any third party, including affiliates of the IDI. Also, an IDI cannot rely on the standards of a government-sponsored enterprise. Accordingly, to qualify for this exemption, the IDI, independently and using its own credit policies and procedures, must itself review and approve each extension of credit before giving a purchase commitment to its affiliate.

5. *Purchase of loans from an affiliate must be without recourse*. In connection with an IDI's purchase of loans from an affiliate, the affiliate cannot retain recourse on the loans. The rule (section 223.42(k)) specifies that the exemption does not apply in situations where the affiliate retains recourse on the loans purchased by the IDI. The rule also specifies that the purchase exemption only applies in situations where the IDI purchases loans from an affiliate that were originated by the affiliate. The exemption cannot be used by an IDI to purchase loans from an affiliate that the affiliate purchased from another lender. The exemption is designed to facilitate an IDI's using its affiliate as an origination agent, not to permit an IDI to take loans off an affiliate's books that the affiliate purchased from a third party.

2020.1.12 OTHER BOARD-APPROVED EXEMPTIONS FROM SECTION 23A

Section 23A gives the Board the authority to grant exemptions from the statute's restrictions if such exemptions are "in the public interest and consistent with the purposes of this section" (12 U.S.C. 371c(f)(2)). Regulation W includes several exemptions that are available to qualifying IDIs.

2020.1.12.1 Exemptions and Interpretation from the Attribution Rule of Section 23A

The attribution rule of section 23A provides that "a transaction by a member institution with any person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate" (12 U.S.C. 371c(a)(2)). One respective interpretation and three exemptions are discussed below.

2020.1.12.2 Interpretation—Loans to a Nonaffiliate that Purchases Securities or Other Assets Through a Depository Institution Affiliate Agent or Broker

In Regulation W, the Board issued an interpretation (12 C.F.R. 223.26(b)) regarding an IDI's loan to a nonaffiliate that purchases assets through an institution's affiliate that is acting as agent. This interpretation confirms that section 23A of the FRA does not apply to extensions of credit an IDI grants to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as (1) the affiliate is acting exclusively as an agent or broker in the transaction and (2) the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

Under this interpretation, the Board concluded that when the affiliated agent or broker retains a portion of the loan proceeds as a fee or commission, the portion of the loan not retained by the affiliate as a fee or commission would still be outside the coverage of section 23A. However, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board, however, granted an exemption from section 23A for that portion of a loan to a third party that an affiliate retains as a market-rate brokerage or agency fee. (See 12 C.F.R. 223.16(c)(2).)

The interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold from the inventory of, another affiliate of the depository institution. In that case, the proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the assets on a principal basis to the third party.

The above-mentioned transactions are subject to the market-terms requirement of section 23B, which applies to "any transaction in which an affiliate acts as an agent or broker or receives a

77. See, for example, SR-97-21.

fee for its services to the institution or any other person'' (12 U.S.C. 371c-1(a)(2)(D)). A market-rate brokerage commission or agency fee refers to a fee or commission that is no greater than that prevailing at the same time for comparable agency transactions the affiliate enters into with persons who are neither affiliates nor borrowers from an affiliated depository institution. (See Regulation W at 12 C.F.R. 223.16(b).)

2020.1.12.3 Exemption—Loans to a Nonaffiliate that Purchases Securities from a Depository Institution Securities Affiliate that Acts as a Riskless Principal

The Board has granted an exemption in Regulation W from section 23A of the FRA for extensions of credit by an IDI to customers who use the loan proceeds to purchase a security that is issued by a third party through a broker-dealer affiliate of the institution that acts as riskless principal. The exemption for riskless-principal transactions would not apply if the broker-dealer affiliate sold to the third-party borrower securities that were issued or underwritten by, or sold out of the inventory of, an affiliate of the depository institution. Riskless-principal trades, although the functional equivalent of securities brokerage transactions, involve the purchase of a security by the depository institution's broker-dealer affiliate. Accordingly, the broker-dealer retains the loan proceeds at least for some moment in time.

There is negligible risk that loans that a depository institution makes to borrowers to engage in riskless-principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, the Board adopted an exemption from section 23A to cover riskless-principal securities transactions engaged in by depository institution borrowers through broker-dealer affiliates of the depository institution. This exemption is applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate markup for executing the riskless-principal securities trade. (See Regulation W at 12 C.F.R. 223.16(c)(1) and (2).)

2020.1.12.4 Exemption—Depository Institution Loan to a Nonaffiliate Pursuant to a Preexisting Line of Credit and the Proceeds Are Used to Purchase Securities from the Institution's Broker-Dealer Affiliate

The Board approved an exemption in Regulation W from section 23A for loans by an IDI to a nonaffiliate pursuant to a preexisting line of credit, in which the loan proceeds are used to purchase securities from a broker-dealer affiliate. In more detail, the Board exempted extensions of credit by an IDI to its customers that use the credit to purchase securities from a registered broker-dealer affiliate of the institution, so long as the extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit. This line of credit should not have been established in expectation of a securities purchase from or through an affiliate of the institution. The preexisting requirement is an important safeguard to ensure that the depository institution did not extend credit for the purpose of inducing a borrower to purchase securities from or issued by an affiliate. The preexisting line of exemption may not be used in circumstances in which the line has merely been preapproved. (See Regulation W at 12 C.F.R. 223.16(c)(3).)

2020.1.12.5 Exemption—Credit Card Transactions

Regulation W also provides an exemption from section 23A's attribution rule for general-purpose credit card transactions that meet certain criteria. (See section 223.16(c)(4).) The rule defines a general-purpose credit card as a credit card issued by a member institution that is widely accepted by merchants that are not affiliates of the institution (such as a Visa card or Mastercard) if less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the institution. Extensions of credit to unaffiliated borrowers pursuant to special-purpose credit cards (that is, credit cards that may only be used or are substantially used to buy goods from an affiliate of the member institution) are subject to the rule.

The credit card exemption includes several different methods that are provided for a member institution to demonstrate that its credit card meets the 25 percent test. First, if a member institution has no commercial affiliates (other than those permitted for an FHC under section 4 of the BHC Act), the institution would be deemed to satisfy the 25 percent test if the institution has no reason to believe that it would fail the test. (A member institution could use this method of complying with the 25 percent test even if, for example, the institution's FHC controls, under section 4(a)(2), 4(c)(2), or 4(k)(4)(H) of the BHC Act, several companies engaged in nonfinancial activities.) Such a member institution would not be obligated to establish systems to verify strict, ongoing compliance with the 25 percent test. *Most BHCs and FHCs should meet this test.* If an IDI has commercial affiliates (beyond those permitted for an FHC under section 4 of the BHC Act), the institution would be deemed to satisfy the 25 percent test if—

1. the institution establishes systems to verify compliance with the 25 percent test on an ongoing basis and periodically validates its compliance with the test or
2. the institution presents information to the Board demonstrating that its card would comply with the 25 percent test. (One way that a member institution could demonstrate that its card would comply with the 25 percent test would be to show that the total sales of the institution's affiliates are less than 25 percent of the total purchases by cardholders.)

Second, for those member institutions that fall out of compliance with the 25 percent test, there is a three-month grace period to return to compliance before extensions of credit under the card become covered transactions. Third, member institutions that are required to validate their ongoing compliance with the 25 percent test have a fixed method, time frames, and examples for computing compliance.

Example of calculating compliance with the 25 percent test. A member institution seeks to qualify a credit card as a general-purpose credit card under section 223.16, paragraph (c)(4)(ii)(A), of the rule. The member institution assesses its compliance under paragraph (c)(4)(iii) of this section on the 15th day of every month (for the preceding 12 calendar months). The credit card qualifies as a general-purpose credit card for at least three consecutive months. On June 15, 2008, however, the member institution determines that, for the 12-calendar-month period from June 1, 2007, through May 31, 2008, 27 percent of the total value of products and services purchased with the card by all cardholders were purchases of products and services from an affiliate of the member institution. Unless the credit card returns to compliance with the 25 percent limit by the 12-calendar-month period ending August 31, 2008, the card will cease to qualify as a general-purpose credit card as of September 1, 2008. Any outstanding extensions of credit under the credit card that were used to purchase products or services from an affiliate of the member institution would become covered transactions at such time.

2020.1.13 AN IDI'S ACQUISITION OF AN AFFILIATE THAT BECOMES AN OPERATING SUBSIDIARY

Section 223.31 (a)-(c) of the rule provides guidance to an IDI that acquires an affiliate. The first situation is when an IDI directly purchases or otherwise acquires the affiliate's assets and assumes the affiliate's liabilities. In this case, the transaction is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any consideration paid by the IDI for the affiliate's assets (if any) plus the amount of any liabilities assumed by the IDI in the transaction.

Regulation W provides that the acquisition by an IDI of a company that was an affiliate of the IDI before the acquisition is treated as a purchase of assets from an affiliate if (1) as a result of the transaction, the company becomes an operating subsidiary of the IDI and (2) the company has liabilities, or the IDI gives cash or any other consideration in exchange for the securities. The rule also provides that these transactions must be valued initially at the sum of (1) the total amount of consideration given by the IDI in exchange for the securities and (2) the total liabilities of the company whose securities have been acquired by the IDI. In effect, the rule requires IDIs to treat such share donations and purchases in the same manner as if the IDI had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company (plus any separate consideration paid by the IDI for the shares). See 12 C.F.R. 223.31.

Similarly, when an affiliate donates a controlling block of an affiliate's shares to an IDI, a covered transaction occurs if the affiliate has liabilities that the IDI assumes. For example, the parent holding company of an IDI contributes between 25 percent and 100 percent of the voting shares of a mortgage company to the IDI.

The parent holding company retains no shares of the mortgage company. The IDI gives no consideration in exchange for the transferred shares. The mortgage company has total assets of $300,000 and total liabilities of $100,000. The mortgage company's assets do not include any loans to an affiliate of the IDI or any other asset that would represent a separate covered transaction for the IDI upon consummation of the share transfer. As a result of the transaction, the mortgage company becomes an operating subsidiary of the IDI. The transaction is treated as a purchase of the assets of the mortgage company by the IDI from an affiliate under paragraph (a) of section 223.31. The IDI initially must value the transaction at $100,000, the total amount of the liabilities of the mortgage company. Going forward, if the member bank pays off the liabilities, the member bank must continue to value the covered transaction at $100,000. However, if the member bank sells $15,000 of the transferred assets of the mortgage company or if $15,000 of the transferred assets amortize, the IDI may value the covered transaction at $85,000.

A similar situation is when an IDI acquires an affiliate by merger. Because a merger with an affiliate generally results in the IDI's acquiring all the assets of the affiliate and assuming all the liabilities of the affiliate, this transaction is effectively equivalent to the purchase and assumption transaction described in the previous paragraph. Accordingly, the merger transaction also is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any consideration paid by the IDI for the affiliate's assets (if any) plus the amount of any liabilities assumed by the IDI in the transaction.[78]

The assets and liabilities of an operating subsidiary of an IDI are treated in the rule as assets and liabilities of the IDI itself for purposes of section 23A.[79] The rule only imposes asset-purchase treatment on affiliate share transfers when the company whose shares are being transferred to the IDI was an affiliate of the IDI before the transfer. If the transferred company was not an affiliate before the transfer, it would not be appropriate to treat the share transfer as a purchase of assets from an affiliate. Similarly, the rule only requires asset-purchase treatment for affiliate share transfers when the transferred company becomes a subsidiary and not an affiliate of the IDI through the transfer.

If an IDI purchases, or receives a donation, of a partial interest in an entity that remains an affiliate, that transaction is treated as a purchase of, or investment in securities issued by an affiliate. This type of transaction is valued according to its purchase price or carrying value. (See 12 C.F.R. 223.23.)

2020.1.14 STEP-TRANSACTION EXEMPTION (SECTION 223.31(d) AND (e))

Under section 223.31(d) of the rule, an exemption is provided for certain step transactions that are treated as asset purchases under section 223.31(a) when an affiliate owned the transferred company for a limited period of time. Regulation W provides an exemption when a company acquires the stock of an unaffiliated company and, immediately after consummation of the acquisition, transfers the shares of the acquired company to the holding company's subsidiary IDI. For example, a bank holding company acquires 100 percent of the shares of an unaffiliated leasing company. At that time, the subsidiary IDI of the holding company notifies its appropriate federal banking agency and the Board of its intent to acquire the leasing company from its holding company. On the day after consummation of the acquisition, the holding company transfers all of the shares of the leasing company to the IDI. No material change in the business or financial condition of the leasing company occurs between the time of the holding company's acquisition and the IDI's acquisition. The leasing company has liabilities. The leasing company becomes an operating subsidiary of the IDI at the time of the transfer. This transfer by the holding company to the IDI, although deemed an asset purchase by the IDI from an affiliate under paragraph (a) of section 223.31, would qualify for the exemption in paragraph (d) of section 223.31.

The rule exempts these "step" transactions under certain conditions. First, the IDI must acquire the target company immediately after the company became an affiliate (by being

78. As noted, section 223.3(dd) of the rule makes explicit the Board's view that these merger transactions generally involve the purchase of assets by a member bank from an affiliate.

79. Because an IDI usually can merge a subsidiary into itself, transferring all the shares of an affiliate to an IDI often is functionally equivalent to a transaction in which the bank directly acquires the assets and assumes the liabilities of the affiliate. In a direct acquisition of assets and assumption of liabilities, the covered-transaction amount would be equal to the total amount of liabilities assumed by the IDI.

acquired by the bank's holding company, for example). The IDI must acquire the entire ownership position in the target company that its holding company acquired. Also, there must be no material change in the business or financial condition of the target company during the time between when the company becomes an affiliate of the IDI and when the IDI is in receipt of the company. Finally, the entire transaction must comply with the market-terms requirement of section 23B, and the IDI must notify its appropriate federal banking agency and the Board, at or before the time that the target company becomes an affiliate of the IDI, of its intent ultimately to acquire the target company.

Regulation W requires that the IDI consummate the step transaction immediately to ensure the quality and fairness of the transaction. To the extent that the IDI acquires the target company some time after the company becomes an affiliate, the transaction looks less like a single transaction in which the IDI acquires the target company and more like two separate transactions, the latter of which involves the IDI acquiring assets from an affiliate.

The Board recognized, however, that banking organizations may need a reasonable amount of time to address legal, tax, and business issues relating to an acquisition. Regulation W thus permits IDIs to avail themselves of the step-transaction exemption if the IDI acquires the target company within three months after the target company becomes an affiliate so long as the appropriate federal banking agency for the IDI has approved the longer time period.

The 100 percent ownership requirement (that the IDI must acquire the entire ownership position in the target company that its holding company acquired) prevents a holding company from keeping the good assets of the target company and transferring the bad assets to the holding company's subsidiary IDI. If a banking organization cannot meet the terms of the step-transaction exemption, the organization may be able to satisfy the conditions of the rule's internal-corporate-reorganization exemption or may be able to obtain a case-by-case exemption from the Board.

2020.1.14.1 Application of Sections 23A and 23B of Subpart G to U.S. Branches and Agencies of Foreign Banks

2020.1.14.1.1 Applicability of Sections 23A and 23B to Foreign Banks Engaged in Underwriting Insurance, Underwriting or Dealing in Securities, Merchant Banking, or Insurance Company Investment in the United States.

By its terms, sections 23A and 23B of the FRA do not apply to the U.S. branches, agencies, or commercial lending offices of foreign banks. The Board, however, used the authority granted to it by the Gramm-Leach-Bliley Act to impose restrictions on transactions between the branches, agencies, and lending offices and any affiliate of the foreign bank that operates in the United States in order to ensure that such transactions met certain prudential standards and provided competitive equality with U.S. banking organizations. The Board accomplished these goals by imposing the definition of affiliates within sections 23A and 23B on transactions between the branches, agencies, and lending offices and those affiliates if the company is also

1. directly engaged in the United States in certain activities. These activities are significant because a U.S. bank cannot engage in these activities directly or through an operating subsidiary and the 23A and 23B limitations help ensure competitive equality between U.S. banks and foreign banks. These activities are as follows:
   - Insurance underwriting pursuant to section 4(k)(4)(B) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(B));
   - Securities underwriting, dealing, or market making pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 USC 1843(k)(4)(E));
   - Merchant banking activities pursuant to section 4(k)(4)(H) of the Bank Holding Company Act (12 USC 1843(k)(4)(H)) (but only to the extent that the proceeds of the transaction are used for the purpose of funding the affiliate's merchant banking activities);
   - Insurance company investment activities pursuant to section 4(k)(4)(I) of the Bank Holding Company Act (12 USC 1843(k)(4)(I)); or

   - Any other activity designated by the Board.
2. a portfolio company (as defined in the merchant banking subpart of Regulation Y (12 CFR 225.177(c)) controlled by the foreign bank or an affiliate of the foreign bank or a company that would be an affiliate of the branch, agency, or commercial lending company of the foreign bank under paragraph (a)(9) of section 223.2 if such branch, agency, or commercial lending company were a member bank; or
3. a subsidiary of an affiliate as described in paragraph (b)(1) or (2) of section 223.61.

Regulation W also provides that for purposes of subpart G, the "capital stock and surplus" of a U.S. branch, agency, or commercial lending company of a foreign bank will be determined by reference to the capital of the foreign bank as calculated under its home-country capital standards.

2020.1.15 SECTION 23B OF THE FEDERAL RESERVE ACT

Section 23B of the FRA became law on August 10, 1987, as part of the Competitive Equality Banking Act of 1987. This section also regulates transactions with affiliates. Section 23B applies to any covered transaction with an affiliate, but excludes banks from the term "affiliate" as that term is defined in section 23A.

Regulation W, subpart F, sets forth the principal restrictions of section 23B. These include (1) a requirement that most transactions between an IDI and its affiliates be on terms and circumstances that are substantially the same as those prevailing at the time for comparable transactions with nonaffiliates; (2) a restriction on an IDI's purchase, as fiduciary, of assets from an affiliate unless certain criteria are met; (3) a restriction on an IDI's purchase, during the existence of an underwriting syndicate, of any security if a principal underwriter of the security is an affiliate; and (4) a prohibition on publishing an advertisement or entering into an agreement stating that an IDI will be responsible for the obligations of its affiliates. For the most part, subpart F restates the operative provisions of section 23B.

The following transactions with affiliates are covered by section 23B:

1. Any covered transaction with an affiliate.
2. The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase.
3. The payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.
4. Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the institution or to any other person.
5. Any transaction or series of transactions with a nonaffiliate if an affiliate
   - has a financial interest in the third party or
   - is a participant in the transaction or series of transactions.

Any transaction by an IDI or its subsidiary with any person is deemed to be a transaction with an affiliate of the institution if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate. An IDI and its subsidiaries may engage in transactions covered by section 23B of the FRA, but only on terms and under certain circumstances, including credit standards, that are substantially the same or at least as favorable to the institution as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. If comparable transactions do not exist, the transaction must be on terms and under circumstances, including credit standards, that in good faith would be offered to or applied to nonfinancial companies.

Section 23B restricts the following transactions with affiliates:

1. An IDI or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted (1) under the instrument creating the fiduciary relationship, (2) by court order, or (3) by law of the jurisdiction creating the fiduciary relationship.
2. An IDI or its subsidiary, whether acting as principal or fiduciary, cannot knowingly purchase or acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of the institution. This limitation applies unless the purchase or acquisition of the security has been approved before it is initially offered for sale to the public by a majority of the directors of the institution. The purchase should be based on a determination that it is a sound investment for the

institution, irrespective of the fact that an affiliate is a principal underwriter of the securities.

2020.1.15.1 Transactions Exempt from Section 23B of the Federal Reserve Act

The market-terms requirement of section 23B applies to, among other transactions, any ‘‘covered transaction’’ between an IDI and an affiliate.[80] Section 23B(d)(3) makes clear that the term ‘‘covered transaction’’ in section 23B has the same meaning as the term ‘‘covered transaction’’ in section 23A, but does not include any transaction that is exempt under section 23A(d). For example, transactions between sister banks and IDIs that are part of a chain banking organization are exempt from section 23B;[81] Also exempt are transactions that are fully secured by a deposit account or U.S. government obligations, and purchases of assets from an affiliate at a readily identifiable and publicly available market quotation.[82] Consistent with the statute, Regulation W’s section 223.52(a)(1) exempts from section 23B any transaction that is exempt under section 23A(d).[83]

The rule also excludes from section 23B any covered transaction that is exempt from section 23A under section 223.42(i) or (j) (that is, asset purchases by a newly formed IDI and transactions approved under the Bank Merger Act). The Board excluded from section 23B this additional set of transactions because, in each case, the appropriate federal banking agency for the IDI involved in the transaction should ensure that the terms of the transaction are not unfavorable to the IDI.

2020.1.15.2 Purchases of Securities for Which an Affiliate Is the Principal Underwriter

The GLB Act amended section 23B to permit an IDI to purchase securities during an underwriting conducted by an affiliate if the following two conditions are met. First, a majority of the directors of the IDI (with no distinction drawn between inside and outside directors) must approve the securities purchase before the securities are initially offered to the public. Second, such approval must be based on a determination that the purchase would be a sound investment for the IDI regardless of the fact that an affiliate of the IDI is a principal underwriter of the securities.[84] Section 223.53(b) includes this standard and clarifies that if an IDI proposes to make such a securities purchase in a fiduciary capacity, then the directors of the IDI must base their approval on a determination that the purchase is a sound investment for the person on whose behalf the IDI is acting as fiduciary.

An IDI may satisfy this director-approval requirement by obtaining specific prior director approval of each securities acquisition otherwise prohibited by section 23B(b)(1)(B). The rule clarifies, however, that an IDI also satisfies this director-approval requirement if a majority of the IDI’s directors approve appropriate standards for the IDI’s acquisition of securities otherwise prohibited by section 23B(b)(1)(B), and each such acquisition meets the standards adopted by the directors. In addition, a majority of the IDI’s directors must periodically review such acquisitions to ensure that they meet the standards and must periodically review the standards to ensure they meet the ‘‘sound investment’’ criterion of section 23B(b)(2). The appropriate period of time between reviews would vary depending on the scope and nature of the IDI’s program, but such reviews should be conducted by the directors at least annually. Before the passage of the GLB Act, Board staff informally allowed IDIs, based on the legislative history of section 23B, to meet the director-approval requirement in this fashion, and there is no indication that Congress in the GLB Act intended to alter the procedures that a member bank could use to obtain the requisite director approval. The rule codifies staff’s preexisting approach to the director-approval requirement.

2020.1.15.3 Definition of Affiliate under Section 23B

Section 23B states that the term ‘‘affiliate’’ under section 23B has the meaning given to such terms in section 23A, except that the term ‘‘affiliate’’ under section 23B does not include a

80. 12 U.S.C. 371c-1(a)(2)(A).

81. Although transactions between banks are exempt from section 23B, the safety-and-soundness provisions of section 23A(a)(4) apply and generally require that transactions be conducted on terms similar to those terms and standards outlined in section 23B.

82. 12 U.S.C. 371c-1(d)(3).

83. Regulation W will again be subsequently referred to as the ‘‘rule’’ or by its specified section-numbered discussion of section 23B provisions.

84. See 12 U.S.C. 371c-1(b)(2).

"bank," as defined in section 23A. In the case of the sister-bank exemption, the rule's section 223.2(c) clarifies that the only companies that qualify for the "bank" exception to section 23B's definition of affiliate are IDIs.

2020.1.15.4 Advertising and Guarantee Restriction

In section 23B(c), the "advertising restriction" prohibits an IDI from publishing any advertisement or entering into any agreement stating or suggesting that the IDI shall in any way be responsible for the obligations of its affiliates. Regulation W clarifies this restriction to permit such guarantees and similar transactions if the transaction satisfies the quantitative and collateral restrictions of section 23A. The rule also clarifies that section 23B(c) does not prohibit an IDI from making reference to such a guarantee, acceptance, or letter of credit in a prospectus or other disclosure document, for example, if otherwise required by law.

2020.1.16 INSPECTION OBJECTIVES

1. To analyze and assess the financial impact of transactions (including loans and purchases of assets) between the IDIs and their subsidiaries and all affiliates.
2. To ascertain if all:
   a. credit transactions are properly secured; and
   b. covered transactions are consistent with the quantitative limits of section 23A.
3. To ascertain whether the IDIs are calculating credit exposure resulting from derivatives and securities borrowing and lending transactions. Also, to ascertain that any credit exposure is secured.
4. To determine if an IDI has engaged in a transaction with a third party when the proceeds are used for the benefit of, or transferred to, an affiliate.
5. To determine if an IDI has procedures for allowing intraday credit.
6. To determine whether covered transactions between a subsidiary IDI (and its subsidiaries), its holding company, and other affiliates are conducted consistent with the quantitative and collateral requirements of sections 23A and 23B of the FRA and Regulation W.
7. To determine if transactions between a subsidiary IDI and its affiliates in the holding company are on terms and conditions and under circumstances, including credit standards, are consistent with safe and sound banking practices and whether the terms and conditions of the transactions are the same as those that would be offered or applied to nonaffiliated companies.
8. To determine whether a subsidiary IDI or its subsidiary
   a. has purchased low-quality assets or
   b. has purchased, as fiduciary, any securities or other assets from an affiliate in the holding company.
9. To determine whether a subsidiary IDI, or any subsidiary or affiliate of the IDI, has published any advertisement or has entered into any agreement that states or suggests that it will, in any way, be responsible for the obligations of affiliates.
10. To determine if securities were purchased or acquired by the subsidiary IDI or its subsidiaries from an underwriting or selling syndicate affiliated with the IDI and, if so, if the majority of outside directors of the IDI approved the purchase or acquisition of securities before they were offered for sale to the public.
11. To confirm that the subsidiary IDI or its subsidiary has not purchased as fiduciary any securities or other assets from a nonbank affiliate in the holding company unless the purchase was permitted in accordance with the instrument creating the fiduciary relationship, by court order, or by the law governing the fiduciary relationship.
12. To ascertain if any subsidiary IDI (or its subsidiary) had knowingly purchased or acquired any security from an affiliate in which the principal underwriter of that security was a nonbank affiliate within the holding company organization.
13. To determine if the subsidiary IDI and its subsidiaries have conducted transactions with their parent holding company or any other company affiliated in the holding company organization that are not in compliance with the restrictions in sections 23A and 23B of the FRA or Regulation W.

2020.1.17 INSPECTION PROCEDURES

1. During the pre-inspection, perform the following activities:

   a. Review examination reports of subsidiary IDIs for comments on loans to affiliates, intercompany transactions, other transactions with affiliates, and violations of the restrictions of sections 23A or 23B of the FRA, or Regulation W.
   b. Review the most current FR Y-8 (The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates).
2. In the officer's questionnaire, request a list of subsidiary IDIs and their subsidiaries' transactions with affiliates since the previous inspection, including the amounts, types, and any collateral, consisting of—
   a. loans or extensions of credit to an affiliate, and purchases of extensions of credit from an affiliate;
   b. a purchase or sale of an investment in securities issued by, or sold to, the affiliate, or purchase or sale of other assets, including assets subject to an agreement to repurchase;
   c. the acceptance of securities or other debt instrument issued by the affiliate as collateral security for a loan or extension of credit;
   d. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit on behalf of an affiliate;
   e. a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate;
   f. a derivative transaction, as defined in 12 U.S.C. 84(b), with an affiliate, to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate.
   g. the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise;
   h. transactions in which an affiliate acts as agent or broker or receives a fee for its services to the bank or to any other person;
   i. any transaction or series of transactions with a third party if—
      (1) the affiliate has a financial interest in the third party or
      (2) the affiliate is a participant in such transactions; and
   j. Any transaction by a subsidiary bank or its subsidiary with any person, if the proceeds of that transaction are used for the benefit of, or transferred to, the affiliate.
3. During the BHC's inspection, perform the following activities:
   a. Review the bank holding company's policies and procedures regarding intercompany transactions of subsidiary banks.
   b. Determine if the substantive transactions of the holding company organization comply with the restrictions on transactions with affiliates in sections 23A and 23B of the FRA and Regulation W.
   c. Verify that covered transactions count against Regulation W's limits and are collateralized when required.
      (1) Ensure that covered transactions are properly valued and adequately collateralized;
      (2) Review collateral documentation to ensure that a lien is adequately perfected and prioritized.
      (3) Review all related documentation, terms, conditions, and circumstances for each transaction, including any resolutions for securities purchased (or established standards for securities purchased from affiliates).
      (4) Determine the purpose and use of the transaction's proceeds.
   d. Review all outstanding guarantees, endorsements, or pledge agreements by the bank to support the affiliates' borrowings.
   e. Review, on a test-sample basis, advertisements and written agreements to ascertain whether the bank or any subsidiary or affiliate of the bank has stated or suggested that it shall be responsible for the obligations of any affiliates in the holding company organization.
   f. If the BHC engages in derivative transactions with affiliates, review the BHC's policies and procedures to determine if credit limits, collateral restrictions, and other limitations (each affiliate and all affiliates combined) have been imposed on interaffiliate derivative transaction (IDI) exposures to affiliates.
      (1) Determine if the limits are similar to those imposed on nonaffiliated counterparties.
   g. Review the listed transactions of the BHC or its subsidiary with the affiliates

that the IDI claims are exempt under 12 C.F.R. 223.42(k) provided in response to the officer's questionnaire (item 2). Determine if

(1) extensions of credit, and purchases of extensions of credit, are supported by independent credit evaluations and if advance loan commitments are provided before the affiliates make loans;
(2) no blank advance purchase commitments exist to purchase loans; and
(3) the purchases meet the quantitative restrictions of the exemption.

4. Give additional attention to the following problems involving the BHC and its subsidiaries:
   a. The subsidiary IDI would not have made the loan or would not have made the loan with such favorable terms and conditions, or engaged in any other covered transaction, except for the parent holding company's insistence due to the affiliate relationship.
   b. The IDI's condition is weakened due to the extension of credit or the nature of the transaction with the affiliate.
   c. The affiliate has not provided adequate qualifying collateral to support the loan or extension of credit provided by the subsidiary IDI.
   d. The IDI does not have a perfected security interest in the collateral.
   e. The loan, extension of credit, or transaction with an affiliate is not in compliance with the limits and restrictions in sections 23A or 23B of the FRA or Regulation W.
   f. Purchases of low-quality assets by a subsidiary bank or its subsidiaries from an affiliate, unless previously exempted by the Board's Regulation W, Board order, or unless the IDI subsidiary or subsidiary affiliate, pursuant to an independent credit evaluation, had committed itself to purchase the low-quality assets before the time such asset was acquired by the affiliate.
   g. During the existence of any underwriting or selling syndicate, a subsidiary IDI or its subsidiary has purchased or acquired a security from an IDI affiliate or bank holding company affiliate, including an affiliated broker-dealer, and the principal underwriter of that security is an affiliate of the IDI.
   h. The purchase or acquisition of securities (1) was not approved by a majority of the outside board of directors before the IDI's securities were offered for sale to the public and (2) was not, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would have been offered to, or would have applied to, nonaffiliated companies.
   i. The existence of advertisements or agreements that state or suggest that the IDI, its subsidiaries, or affiliate will be responsible for the obligations of its affiliates.
5. Review any checking accounts and IDI statements to check for overdrafts the parent company or any of its nonbank subsidiaries may have with a subsidiary IDI.
6. Review the accounts payable to the subsidiary IDI and other accounts payable accounts for servicers, contractors, lessors, and other affiliates to determine if they arose as the equivalent of an extension of credit, purchase of securities or other assets, or as a liability to third parties. Ascertain whether those transactions were listed in response to the officer's questionnaire and whether the transactions were in accordance with the restrictions in sections 23A and 23B of the FRA and Regulation W.
7. Review the accounts receivable from the subsidiary IDI and other accounts receivable of other affiliates for sales of securities or other assets and for the payment of money or the furnishing of services. Ascertain whether those transactions were reported in response to an officer's questionnaire and whether they are in accordance with section 23A and 23B of the FRA's and Regulation W's restrictions placed on transactions with affiliates.
8. Ascertain if the IDI's credit limits, collateral requirements, and monitoring of its exposures to affiliates are at least as strict as those it imposes on unaffiliated companies.
9. Determine if the IDI has policies and procedures to monitor and control its intraday credit exposure to each affiliate and to all affiliates in the aggregate.
10. Determine if the IDI's intraday extensions of credit to affiliates are on comparable market terms and if they comply with section 23B of the FRA.

11. Review all other transactions that the holding company organization has engaged in with its affiliated IDIs and their subsidiaries, including lease arrangements, to determine whether they are subject to the restrictions in sections 23A and 23B and Regulation W, and, if so, whether they are in compliance.
12. Discuss the findings with appropriate senior management and, if the findings are significant, the board of directors.
13. Determine management's corrective actions regarding any comments raised by the bank's primary regulator in an examination report.
    a. If violations are disclosed in a subsidiary bank's examination report or during an inspection of the holding company, the examiner may criticize management on the "Examiner's Comments and Matters Requiring Special Board Attention" page or section of the inspection report for causing the bank to be in violation or for engaging in unsafe and unsound practices.
    b. If loans to or transactions with affiliates within the holding company organization appear to adversely affect a subsidiary bank, request management's assessment of such effects and its rationale for the transactions. Use of the "Examiner's Comments and Matters Requiring Special Board Attention" report page or section may be appropriate.

2020.1.18 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*FRRS* [3]	*Orders*
Regulation W		223		
Treatment of transactions with financial subsidiaries of banks	371c(e), FRA section 23A	208.73(d)	3-383.1	
Limitations on amount—loans secured by paper eligible for rediscount or purchase by a Federal Reserve Bank	371c, FRA section 23A(c)	223.14(b)(i)(C)		
Applicability to FDIC-insured banks	1828(j), FDIA section 18(j)		1-398	
Restrictions on transactions with affiliates	371c-1, FRA section 23B		3-1116	
Market terms requirement—derivative transactions with affiliates		223.33		
Intraday extensions of credit by insured depository institutions to their affiliates		223.42(l)		
Exemptions-loans and extensions of credit by member bank to a third party		223.16(c)(3)		
Securities issued by an affiliate cannot be used as collateral for a loan to any affiliate	1813, Dodd-Frank Act 371c(c)(4)			
Credit exposure resulting from a derivative transaction with an affiliate is a covered transaction	371c(b)(7)(G)			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2010, this section was revised to include a cross reference to section 2010.2.7 of this manual, which discusses loan participations. References in the table of Laws, Regulations, Interpretations, and Orders have also been updated.

It is common practice for a bank to sell to or place with other banks loans that the bank itself has made to its customers. A loan participation is a share or part of a loan which entitles the holder to a pro rata share of the income determined by the extent of the holder's contribution to the original loan and a preference ordering for repayment. Such loans may be sold outright without liability to the selling bank in case of default by the borrower, or they may be sold with terms granting the purchasing bank recourse to the selling bank should the loans become uncollectible. Sales to or placement of loans with other banks are for the accommodation of either the selling or purchasing bank and are arranged for purposes of increasing the rate of return when loan rates differ between banks, achieving diversification of loans by type, and altering liquidity positions. It is also common practice for banks to sell or place with other banks those portions of individual loans that would be in excess of the bank's legal lending limit (overlines) if the total loan were retained. Participations of this type should be placed without recourse as a matter of prudent banking practice; otherwise, the purpose of compliance with the legal lending limitations would be defeated in the event of default. See section 2010.2.7 of this manual for supervisory and accounting guidance regarding a BHC's or bank's use, purchase, or sale of loan participation agreements.

Banks also sell or place loans or participations with their parent holding companies or nonbank affiliates. A BHC's purchase of loan participations from its subsidiary bank(s) generally constitutes the making of a loan or extension of credit within the meaning of section 225.28(b)(1) of Regulation Y, and as such, a BHC needs prior approval to purchase loan participations from its subsidiary bank(s).

A bank may participate in or purchase a loan originated by its parent holding company or one of its nonbank subsidiaries. A subsidiary bank's purchase, or participation of a loan, note, or other asset from an affiliate is considered a purchase of an asset from an affiliate within the meaning of section 23A of the Federal Reserve Act and thus is a "covered transaction" that is subject to the quantitative limitations and the prohibition against purchasing of low-quality assets. Subsidiary banks must make independent judgments as to the quality of such participations before their purchase to avoid compromising the asset quality of such banks for the benefit of other holding company entities. All loans and participations must be purchased on market terms.

A bank's purchase of a loan or loan participation, on a nonrecourse basis from an affiliate, may not be a covered transaction under section 23A that is subject to the quantitative limitations (12 C.F.R. 223.11- 223.12)), collateral requirements (12 C.F.R. 223.14), and low-quality asset prohibition (12 C.F.R. 223.15) if

1. the extension of credit was originated by the affiliate;
2. the member bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit;
3. the member bank commits to purchase the extension of credit before the affiliate makes or commits to make the extension of credit;
4. the member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate; and
5. the dollar amount of the extension of credit, when aggregated with the dollar amount of all other extensions of credit purchased from the affiliate during the preceding 12 calendar months by the member bank and its depository institution affiliates, does not represent more than 50 percent (or such lower percent as is imposed by the bank's appropriate Federal banking agency) of the dollar amount of extensions of credit originated by the affiliate during the preceding 12 calendar months. (See 12 C.F.R. 223.42(k).)

In some cases, a bank may renew a loan or a participation that it purchased from another affiliated bank even when the original participation has become a low-quality asset. In some instances, a bank's renewal of a low-quality asset, such as a troubled agricultural loan, or an extension of limited amounts of additional credit to such a borrower may enable both the originating and participating banks to avoid or minimize potential losses. It would be inconsistent with the purposes of section 23A to bar a participating bank from using sound banking judgment to take the steps that it may deem necessary to protect itself from harm in such a situation, so long as the loan was not a low-quality asset at the time of the original participation and the participating bank does not assume more than its original proportionate share of the credit.

The following factors thus characterize the situation where it would be reasonable to interpret section 23A as not applying to the renewal of an otherwise low-quality asset:

1. the original extension of credit was not a low-quality asset at the time the affiliated bank purchased its participation,
2. the renewal and/or the extension of additional credit has been approved by the board of directors of the participating bank as necessary to protect the bank's investment by enhancing the ultimate collection of the original indebtedness, and
3. the participating bank's share of the renewal and/or additional loan will not exceed its proportionate share of the original investment by more than 5 percent. In addition, it is expected that, consistent with safe and sound banking practices, the originating bank would make its best efforts to obtain adequate collateral for the loan(s) to further protect the banks from loss. (See 12 C.F.R. 223.15.)

Loans and loan participations by the various members of the holding company family to individual borrowers or to the same or related interests may represent concentrations of credit which are large in relation to the holding company's consolidated capital position. These concentrations of credit should be assessed for potentially harmful exposure to the holding company's financial condition.

2020.2.1 INSPECTION OBJECTIVES

1. To determine the BHC's loan participation policy.
2. To assess the impact of a subsidiary bank's participation in loans with affiliates and to ensure that the bank's financial condition is not compromised and that the bank is not providing the funding needs of the affiliates, except within the parameters of sections 23A and 23B of the Federal Reserve Act.
3. To assess the impact of any concentrations of credit on the holding company's overall financial position.

2020.2.2 INSPECTION PROCEDURES

1. During the preinspection process, review each subsidiary bank's examination report for comments on participations with affiliates.
2. In the officer's questionnaire to the holding company, request the BHC's policy on loan participation. Request a list of any loan participations the holding company or the nonbank subsidiaries have with the subsidiary bank(s).
3. During the inspection, review the policy statements and each participation the holding company or the nonbank subsidiaries have with the subsidiary bank(s). The following characteristics should be analyzed:
   a. any repetitive transaction patterns which may indicate policy;
   b. the adequacy of credit information on file;
   c. the extent to which the terms of the participation including interest rates are handled in an arm's-length manner;
   d. the degree that the bank is accommodating the funding needs of the nonbank subsidiaries or its parent;
   e. the impact of these transactions on the subsidiary bank;
   f. eligibility for exclusion from section 23A restrictions and, if applicable, compliance with such restrictions.
4. Review participations among the bank holding company, nonbank subsidiaries, and the subsidiary banks to determine potentially adverse concentrations of credit.
5. Discuss with management—
   a. written and verbal policies regarding participations both within the holding company and with nonaffiliated third parties and
   b. any adverse findings on intercompany participations.
6. Comment on policy on the appropriate page of the inspection report (see section 5010.6). If any adverse comments on participations with affiliates are contained in a bank subsidiary's examination report, comment on their current status and the BHC's efforts to remedy the problem.

2020.2.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Limitations and restrictions	371c, FRA section 23A(c)			
Purchase of extensions of credit from affiliates		223.42(k)	3–1161	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Sales and transfers of assets between subsidiary banks and other entities in a bank holding company organization pose the potential of risk to the subsidiary banks. Asset purchases are covered by Section 23A and Section 23B of the Federal Reserve Act. The limitations state that all covered transactions, including asset purchases, by a bank with a single affiliate, may not exceed 10 percent of a bank's capital and surplus, and transactions with all affiliates may not exceed 20 percent of the bank's capital and surplus. In addition, all transactions must be conducted on market terms.

A bank's purchase of a loan or loan participation from a bank holding company or its subsidiary may not be a covered transaction under Section 23A if:

1. the bank makes an independent credit evaluation on each loan prior to the affiliate making the loan;
2. the bank agrees to purchase the loan prior to the affiliate making the loan; and
3. the bank's purchase of the affiliate's loans is not the primary source of funding for the affiliate.

Sale and transfer of assets can also occur through swaps and spinoffs. Examples of such transactions which may have an adverse effect on a bank include the transfer of a profitable activity or subsidiary from the bank to the holding company, or the transfer of an unprofitable activity or subsidiary from the holding company to the bank. In addition, the transfer of a bank holding company subsidiary to a bank, whereby the bank assumes the liabilities of the affiliate raises supervisory concerns and may violate Sections 23A and 23B of the Federal Reserve Act.

Another example is the transfer of a subsidiary bank's deferred taxes, together with an equivalent amount of cash or earning assets, to the parent. In such a transaction, a subsidiary bank's liquidity position is weakened. All such transfers of deferred taxes must be reversed and the bank's asset and liability accounts restored to their level prior to the transfer. For a detailed discussion on transfers of a bank's deferred tax liability, see Manual section 2070.0.

A bank holding company may transfer a liquidating asset from a subsidiary bank to a section 4(c)(1)(D) liquidating subsidiary of the holding company. Also, pursuant to section 4(c)(3) of the Act, a BHC may transfer from a subsidiary bank an asset to be disposed of pursuant to the request of the bank's primary regulator. For more information on the transfer of such assets and the time parameters involved, refer to Manual section 3030.0.

The purchase of low-quality assets is prohibited by Section 23A of the Federal Reserve Act. Refer to section 2020.1.1.5 for a listing of transactions that are exempt from the limitations of Section 23A of the Federal Reserve Act.

2020.3.1 INSPECTION OBJECTIVES

1. To review intercompany sale and transfer of assets to assess the impact on the subsidiary bank.
2. To initiate corrective action to reverse the transaction, if necessary.

2020.3.2 INSPECTION PROCEDURES

1. During the preinspection process, review all notes to financial statements, the FR Y-8 report, and the examination reports of subsidiary banks to ascertain whether any purchase or transfer of assets has occurred between the subsidiary banks and the parent holding company or nonbank subsidiaries.
2. In the officer's questionnaire, request information on any transfer or sale of assets between the subsidiary bank and the parent holding company or the nonbank subsidiaries.
3. During the inspection, review all facts regarding any sale or transfer of assets transactions and assess their impact on the subsidiary bank. Examiners should determine:
   a. Whether the transaction required and received the approval of the bank's primary regulator; and
   b. The quality of the assets transferred or sold, and whether the sale of the assets was at a price significantly higher than would have been realized in an arm's-length transaction.
4. Discuss findings with management including:
   a. Apparent prejudicial transactions and violations of regulations; and
   b. Any unsound practices.

A compensating balance is a deposit maintained by a firm at a bank to compensate the bank for loans and lines of credit granted to the firm. Often, a commercial bank, when extending credit, requires an average deposit balance equal to a fixed percentage of the outstanding loan balance. Compensating balance requirements vary from informal understandings to formal contracts. Deposits maintained as compensating balances may be demand or time, active or dormant. Frequently, a lending bank will allow compensating balances to be supplied by a depositor other than the borrower itself. If compensating balances are maintained by a BHC's subsidiary bank on behalf of its parent, the practice is considered a diversion of bank income (i.e., the bank loses the opportunity to earn income on the balances that could be invested elsewhere). In general, this practice is inappropriate unless the bank is being compensated at an appropriate rate of interest. If the bank is not being appropriately reimbursed, the practice should be criticized and action taken to insure that the bank is compensated for the use of its funds.

BHCs borrow directly from nonaffiliated banks, using the proceeds for both bank and nonbank operations and investments. Also, bank holding companies seek credit lines from banks to back their borrowings in commercial paper markets and for other liquidity purposes. Nonbank subsidiaries of bank holding companies borrow from banks to fund activities such as mortgage banking, leasing and sales finance. In some cases, when a bank holding company or its nonbank subsidiaries borrow, the subsidiary bank's deposit at the lending institution may be accepted as a compensating balance for the borrowings of other members of the bank holding company organization. Such transactions raise questions under Section 23B of the Federal Reserve Act regarding the bank's compensation for such services.

Often the distinction between correspondent balances and compensating balances is not clear. Occasionally, the rate of the required compensating balance is written into the loan agreement; however, informal understandings usually appear to determine the amount of compensating balance maintained. At times, a balance may be identified in the bank's books as a compensating balance. A compensating balance may also be identified as an amount above a correspondent balance historically maintained by the bank. Compensating balances may also appear as a dormant account or may be the aggregate amount of a number of deposits of various subsidiary banks.

The interest rate on the loan to the holding company organization may also be helpful in determining the existence of compensating balances. Loans below the lending bank's normal rate may indicate that the lending bank is receiving compensation in another form.

At times, excess correspondent balances are maintained to encourage participation relationships and for other goodwill reasons. Therefore, the existence of excess balances may not always indicate that there is a compensating balance agreement.

Although a bank holding company may compensate its subsidiary banks for the use of the funds, the compensation may not equal the opportunity cost associated with providing the compensating balance. As a result, subsidiary banks which maintain compensating balances for holding company members may forego profit opportunities, and this practice may have a negative impact on the bank's earnings and capital adequacy. The amount of such compensation should be equal to a fair market rate.

If the lending bank has the right of offset to compensating balances maintained by the subsidiary bank in case of default by parent or nonbank subsidiaries, the subsidiary bank's funds are jeopardized. Such potential loss of funds should be commented on by the examiner.

2020.4.1 INSPECTION OBJECTIVES

1. To identify compensating balances maintained by a subsidiary bank for the parent holding company or any nonbank affiliate.
2. To determine whether the subsidiary bank is adequately reimbursed for the maintenance of any compensating balances.

2020.4.2 INSPECTION PROCEDURES

1. During the preinspection process:
   a. Review the subsidiary bank examination reports or contact management to determine whether the non-affiliated banks, lending to the holding company organization, are correspondents of the subsidiary banks. Where applicable, request detailed loan information which could

provide information on the compensating balances' terms required by the lending bank.

b. Review the notes to the financial statements and other available material, such as 10–K reports filed with the SEC, which may describe compensating balance agreements. FR Y–8 reports should be reviewed for questions applicable to compensating balances.

2. Review interbank loan agreements to determine whether compensating balances are formally required. Assess the terms of the loan to determine whether the loan appears to be at fair market rates for this type of credit request.

3. Request and review the account balance and monthly account statement provided by the lending bank to identify the amount of compensating balances. The statement should be available within the holding company or bank.

4. Request from management information regarding compensating balances maintained by subsidiary banks for the benefit of other affiliates.

5. Review the subsidiary bank's historical level of correspondent balances to assess trends. Compare levels of balances prior to any loan origination or interest rate changes.

6. Review intercompany accounts to determine the amount of compensation paid to the subsidiary bank for maintaining compensating balances. Assess adequacy of compensation. Assess impact of practice on the bank's financial condition.

7. Discuss with management the reasons for any apparent excess balances, and whether compensating balances are formally or informally required.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2012, this section was revised to update the references within the table of Laws, Regulations, Interpretations, and Orders.

Dividends are a means by which a corporation distributes earnings or assets to its shareholders. Although the word "dividends" usually applies to funds paid out of net profits or surplus and is usually thought of in such a context, dividends can also be made "in kind," which means in property or commodities. This section does not discuss "stock dividends" which represent transfers from retained earnings to paid-in capital rather than distributions of earnings. Dividends from the subsidiaries, both bank and nonbank, to the parent company are the means by which a cash return is realized on the investment in subsidiaries, thus enabling the parent to pay dividends to its shareholders and to meet its debt service requirements and other obligations.

Dividends paid by any corporation are generally limited by certain State laws. Banks, however, are subject to further legal restrictions on dividends by their chartering authority and other regulators. Aside from the statutory limitations, the primary consideration in this area is the subsidiary's level of capital and its ability to meet future capital needs through earnings retention.

Although there are no specific regulations restricting dividend payments by bank holding companies other than State corporate laws, supervisory concern focuses on the holding company's capital position, its ability to meet its financial obligations as they come due, and its capacity to act as a source of financial strength to its subsidiaries. Some one-bank holding companies may be restricted in the amount of dividends they may pay as a result of certain limitations placed on future dividend distributions at the time of the holding company's formation. (see Manual section 2090.2)

When analyzing the dividend practices of the subsidiaries and the parent company the following must be considered: the present level of capital in relation to total assets, risk assets, and classified assets; growth rates and additional plans for expansion; past earnings performance and projections; and the ability to service debt.

Aside from reasonable and timely fees for services rendered, the most appropriate way for funds to be paid by the bank to the parent is through dividends. This principle applies, in general, to bank payments of funds to service holding company debt, even when the debt was initially incurred to raise equity capital for the subsidiary bank. It is not considered an appropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should, as a general rule, be upstreamed in the form of dividends.

2020.5.1 POLICY STATEMENT ON CASH DIVIDEND PAYMENTS

On November 14, 1985 the Board approved a policy statement on the payment of cash dividends by state member banks and *bank holding companies that are experiencing financial difficulties.* The policy statement addresses the following practices of supervisory concern by institutions that are experiencing earnings weaknesses, other serious problems, or that have inadequate capital:

- The payment of dividends not covered by earnings,
- The payment of dividends from borrowed funds,
- The payment of dividends from unusual or nonrecurring gains, such as the sale of property or other assets.

It is the Federal Reserve's view that an organization experiencing earnings weaknesses or other financial pressures should not maintain a level of cash dividends that exceeds its net income, that is inconsistent with the organization's capital position, or that can only be funded in ways that may weaken the organization's financial health. In some instances, it may be appropriate to eliminate cash dividends altogether. The policy statement is as follows:

2020.5.1.1 Policy Statement on the Payment of Cash Dividends by State Member Banks and Bank Holding Companies

The Board of Governors of the Federal Reserve System considers adequate capital to be critical to the health of individual banking organizations and to the safety and stability of the banking system. A major determinant of a bank's or bank holding company's capital adequacy is the strength of its earnings and the extent to which its earnings are retained and added to capital or paid out to shareholders in the form of cash dividends.

Normally, during profitable periods, dividends represent an appropriate return of a portion of a banking organization's net earnings to its shareholders. However, the payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

As a matter of prudent banking, therefore, the Board believes that a bank or bank holding company generally should not maintain its existing rate of cash dividends on common stock unless 1) the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends *and* 2) the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition. Any banking organization whose cash dividends are inconsistent with either of these criteria should give serious consideration to cutting or eliminating its dividends. Such an action will help to conserve the organization's capital base and assist it in weathering a period of adversity. Once earnings have begun to improve, capital can be strengthened by keeping dividends at a level that allows for an increase in the rate of earnings retention until an adequate capital position has been restored.

The Board also believes it is inappropriate for a banking organization that is experiencing serious financial problems or that has inadequate capital to borrow in order to pay dividends since this can result in increased leverage at the very time the organization needs to reduce its debt or increase its capital. Similarly, the payment of dividends based solely or largely upon gains resulting from unusual or nonrecurring events, such as the sale of the organization's building or the disposition of other assets, may not be prudent or warranted, especially if the funds derived from such transactions could be better employed to strengthen the organization's financial resources.

A fundamental principle underlying the Federal Reserve's supervision and regulation of bank holding companies is that bank holding companies should serve as a source of managerial and financial strength to their subsidiary banks. The Board believes, therefore, that a bank holding company should not maintain a level of cash dividends to its shareholders that places undue pressure on the capital of bank subsidiaries, or that can be funded only through additional borrowings or other arrangements that may undermine the bank holding company's ability to serve as a source of strength. Thus, for example, if a major subsidiary bank is unable to pay dividends to its parent company—as a consequence of statutory limitations, intervention by the primary supervisor, or noncompliance with regulatory capital requirements—the bank holding company should give serious consideration to reducing or eliminating its dividends in order to conserve its capital base and provide capital assistance to the subsidiary bank. . . .

This statement of principles is not meant to establish new or rigid regulatory standards; rather, it reiterates what for most banks, and businesses in general, constitutes prudent financial practice. Boards of directors should continually review dividend policies in light of their organizations' financial condition and compliance with regulatory capital requirements, and should ensure that such policies are consistent with the principles outlined above. Federal Reserve examiners will be guided by these principles in evaluating dividend policies and in formulating corrective action programs for banking organizations that are experiencing earnings weaknesses, asset quality problems, or that are otherwise subject to unusual financial pressures.

2020.5.2 INSPECTION OBJECTIVES

1. To assure compliance with statutes and the Board's November 1985, Policy Statement.
2. To determine reasonableness of dividend payout at both the subsidiary and holding company levels.

Depending on the type of charter and membership in the Federal Reserve, all insured commercial banks are subject to certain legal restrictions on dividends. In the case of nonbank subsidiaries and holding companies, there are no specific federal statutes, other than the policy statements discussed, which apply to dividend payments. State corporate laws would apply.

One objective of the inspection process is to check for compliance with these laws and to follow-up on any violations.

In some cases dividends which comply with the regulations still may not be in the best interest of the bank. It is the examiner's responsibility to assess the reasonableness of dividend payments in relation to each subsidiary's capital needs. Evaluation of the holding company's dividend policy and payment requires a review at both the parent company and the consolidated levels. On a consolidated basis the holding company's capital level in relation to the quantity and quality of total assets, earnings history and potential, and growth rates are important in the assessment of a reasonable dividend payout. At the parent level, the method of funding dividends should be reviewed. For example, a well capitalized corporation with strong earnings might pay dividends which could be considered unreasonable if the organization were in a strained liquidity position.

2020.5.3 INSPECTION PROCEDURES

1. Review dividend payments by subsidiaries and the parent company. Check for compliance with appropriate statutes and the Board's November 14, 1985 policy statement on the Payment of Cash Dividends. Discuss violations with management and comment on the "Examiner's Comments and Matters Requiring Special Attention" page.

This step will often require a review of net earnings and changes in the capital accounts in the past years, as legal restrictions on dividends often apply to cumulative income for several years rather than just the year the dividend is actually paid. For this reason detailed working papers are important, as these can help to avoid duplications of effort at future inspections. In some situations the regulations provide that dividends may be paid in excess of current year's earnings. If prior approval from the bank's primary regulator is necessary, verify that it has been obtained. Any violations of dividend statutes should be discussed with management and cited in the "Examiner's Comments and Matters Requiring Special Attention" page of the inspection report.

2. Analyze dividend payouts of subsidiaries and the parent in terms of capital adequacy, earnings and earnings potential.

Discuss excessive dividend payouts at any level with management and comment on the "Examiner's Comments and Matters Requiring Special Attention" page of the inspection report. In assessing the reasonableness of dividend payments by subsidiaries and the holding company, the organization's capital adequacy and future capital needs must be judged with the following in mind: the volume of total assets; asset quality (the percentage of weighted classified assets to gross capital could be used as an indicator of quality); asset mix and liquidity; asset growth rates and projections; and plans for expansion and development of new areas. The subsidiary's or the holding company's ability to augment capital through earnings is also important. If a bank, nonbank or holding company has a consistently strong earnings record and its capital position is healthy, a higher dividend payout may be acceptable than would be otherwise. In analyzing the strength of earnings both quantity and quality must be considered. The actual quality of earnings and earnings potential are related to operating income rather than extraordinary items, significant capital or securities gains, or substantial increases resulting from tax considerations.

3. Review the funding of dividends paid by the holding company. Analyze the parent's cash flow and income statements in accordance with section 4010.0 of this manual. Discuss any inappropriate funding with management and comment on, based on their severity, either on the "Cash Flow Statement (Parent)," or the "Analysis of Financial Factors" and the "Examiner's Comments and Matters Requiring Special Attention" pages.

An analysis of the parent company's cash flow statement supplemented by the income statement will identify the source of cash for dividend payments. The parent company has cash inflow from various sources including: dividends from subsidiaries, income from activities conducted for its own account, interest income on advances to subsidiaries, management and service fees, borrowings, and tax savings resulting from filing a consolidated tax return. Dividends should be internally funded from dividends paid by the subsidiaries, the parent company's earnings from activities for its own account or from interest income on advances to subsidiaries. Should the analysis of the cash flow statement indicate that dividends paid by the parent exceed cash inflow from these sources, further attention to the area is required to determine the actual underlying source of dividend funding. As discussed in the section on management and service fees, these are properly assessed at market value or cost of services rendered. They are not to be charged simply to divert income from subsidiaries in order to pay dividends. Borrowing to fund dividends is fundamentally an unsound practice.

When dividends paid by the holding company are funded by the bank subsidiary, it is possible to control indirectly the holding company's dividend payout level when it is determined to be detrimental to the bank subsidiary. It is important to remember that the primary responsibility of bank regulators is the promotion of safe and sound banking operations. Other than the mentioned policy statement there are no specific federal laws restricting dividends paid by bank holding companies; however, the System's cease and desist authority over bank holding companies does afford the ability to curb excessive dividend payouts.

Whenever the examiner determines that dividend payments at the subsidiary level or parent level are not reasonable, are not in the best interest of the organization, or are not funded in a proper manner, discussion with management and a close look at its philosophy are essential. Remarks on the matter should appear on the "Examiner's Comments and Matters Requiring Special Attention" page of the report.

2020.5.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Dividend limits for national banks	5199(b)			
Dividend limits	5204			
Dividend limits for State member banks	Section 9, F.R. Act			
Capital limitations and earnings limitations on the payment of dividends by state member banks		208.5	3–160	
Board policy statement on assessment of financial factors, one bank holding companies (para. 4 dividend restrictions)		225 appendix C	4–868	1980 FRB 320
Board policy statement on dividends for banking organizations having financial difficulties			4–877	1986 FRB 26

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

A bank holding company is permitted to own nonbank subsidiaries that furnish services to or perform services for its other subsidiaries pursuant to section 4(a)(2)(A), 4(c)(1)(C), or 4(c)(8) of the BHC Act. Many bank holding companies charge fees for providing to their subsidiaries services such as management advice, personnel services, data processing, marketing, supply administration, investment advice, bookkeeping, and trust services. The fees for these services that are assessed against subsidiary banks take many forms and are an area of potential abuse. In addition to direct fees paid to an affiliate, the compensation for providing these services might take the form of salaries or directors' fees paid to the bank holding company's management. A holding company should not, directly or indirectly through other subsidiaries, burden its bank subsidiaries with excessive fees or charge for services unrelated to value received in order to fund its debt service, dividend payments, or support of other subsidiaries.

Examiners should review the fees charged by a holding company's bank and nonbank subsidiaries to any banking subsidiary and judge the reasonableness of those fees by examining the reasonableness of the services provided and the basis for allocating fees. Fees charged nonbank subsidiaries and independent third parties should not be more favorable than fees charged banking subsidiaries. They should be reasonable and justifiable and be based on the fair market value of services provided or, when there is no market established for a particular service, on actual cost plus a reasonable profit. *The market value of similar services is the preferred basis of fee assessment.* When fees are based on cost plus a reasonable profit, there is less incentive for the efficient and effective use of resources, because a profit margin is built in regardless of the costs involved. In many situations, however, the cost method is the only method possible.

Any method of pricing services provided to bank subsidiaries that is based on anything other than value received is inappropriate. The fee mechanism should not be used to divert income from any bank subsidiary to meet the parent's financial needs if those needs are unrelated to the provision of services to that subsidiary. In addition, banks are prohibited from paying management fees* if it would cause the institution to become undercapitalized (see title I, section 131 of the FDIC Improvement Act of 1991 or section 38 of the FDIC Act).

Any fee for services to a banking subsidiary should be supported by evidence that the parent or other affiliate provided the service. Services provided by bank holding companies should serve the needs of the subsidiary bank; charges for services that appear to duplicate existing subsidiary-bank functions should be supported by a detailed explanation of the net benefit derived by the subsidiary bank and by an analysis of the reasonableness of the fee.

When it is impractical to allocate expenses on a direct-charge basis, bank holding companies frequently allocate overhead expenses to subsidiaries. Although this practice can be considered acceptable with regard to nonbanking subsidiaries, allocating all bank holding company expenses to bank subsidiaries is not permitted. The parent company should bear a portion of the costs connected with, for example, the holding company's investor/shareholder relations, regulatory reporting requirements, acquisitions, formations, applications, board of directors, and strategic planning. Bank holding companies are, however, expected to support their subsidiary banks, and expenses incurred to serve the needs of the subsidiary banks, such as expenses incurred in raising capital for subsidiary banks, can appropriately be allocated to those subsidiary banks that benefit from the services provided, in proportion to the benefit received from the service.

All fees for services rendered should be supported by written agreements that describe the service, the fees to be charged, and the method of allocating the fees among the subsidiaries. The absence of such contracts between the subsidiaries of the holding company is considered inappropriate and an unsafe and unsound banking practice. Supervisory action should be taken, in a manner consistent with the financial condition of the holding company and the subsidiary bank, to eliminate the improper practices. The practices should be criticized in the inspection report and actions taken to see that the situation is satisfactorily resolved. If the practices are having a serious impact on the bank, or if they might reasonably be expected to have a severe impact given the bank's financial condition, formal administrative action should be considered in order to require the holding company to terminate the practices and make restitution to the subsidiary bank.

* "Management fees" does not include fees for such services as electronic data processing or auditing.

A bank's prepayment of service fees to the parent company and payment of expenses incurred primarily in conjunction with holding company activities unconnected with the bank also are cause for supervisory concern. In general, prepayment for services is inappropriate unless the bank holding company can demonstrate that prepayment is standard industry practice for nonbanking companies acquiring the same service. Prepayment of sums for services that are not to be provided in the immediate future (for example, prepayment of an entire year's fees for services to be rendered throughout the year) can have an adverse impact on the bank and is therefore inappropriate. These practices should be addressed by requiring timely and reasonable payments for services and reimbursement to the banks for what are essentially holding company expenses. If bank expenses are incurred substantially in support of a holding company activity, the bank should be reimbursed for that portion of its cash outlay that benefits the holding company. Reimbursement is necessary to ensure that bank resources are not diverted to a holding company affiliate with little or no benefit to the bank.

Aside from reasonable and timely fees for services rendered, the most appropriate way, from a supervisory standpoint, for funds to be paid to the parent company is through dividends. This principle applies, in general, to bank payment of funds to service holding company debt, even when the debt was initially incurred to raise equity capital for the subsidiary bank. It is an inappropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should, as a general rule, be upstreamed in the form of dividends.

2020.6.1 TRANSACTIONS SUBJECT TO FEDERAL RESERVE ACT SECTION 23B

Section 23B of the FRA applies to any covered transaction with an "affiliate," as that term is defined in section 23A of the FRA. Section 23B also applies to a number of transactions that are not covered by section 23A, for example, transactions that involve the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise, or transactions in which an affiliate acts as an agent or a broker or receives a fee for its services. Although transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B, section 23A requires that covered transactions between a bank and an affiliate be conducted at arm's length. See section 2020.1.2 for other transactions that are covered by section 23B and the requirements that pertain to all such transactions. For examples of transactions that could violate section 23B, see section 3700.10, dealing with an application to provide armored car services through a bank holding company's nonbank subsidiary.

2020.6.2 INSPECTION OBJECTIVES

1. To determine whether the holding company and its subsidiaries charge fees to bank subsidiaries based on value received and fair market value.
2. To determine whether the subsidiaries are actually receiving these services.
3. To determine that the timing of fee payments is appropriate.
4. To determine whether there is an agreement between the entities relating to specific services and fees charged.
5. To determine if any fees result in an unsafe or unsound condition in any subsidiary bank.

Once the management policy underlying the fee structure is clearly understood, it is important for the examiner to determine that practice is consistent with policy. For example, if management indicates that fees charged are based on the fair market value of services received but the fee structure is actually geared to the bank subsidiary's asset size, an inconsistency exists. Assuming either that all of the bank subsidiaries have access to the same or similar markets for the services being provided by the bank holding company or that cost is used consistently to determine pricing, the established pricing structure should be used for all subsidiaries. Deviations from established policy intended to channel a greater proportion of income from financially sound banks to financially weak ones should be noted.

When it has been established that the fee structure is reasonable and is consistently followed, a final question remains. Are the bank subsidiaries actually receiving the services for which they are charged? This may be difficult to ascertain in many cases, but serious efforts must be made.

It is important that the basic business principles of an arm's-length transaction be applied to all transactions between banks and their affiliates. This approach provides protection for all the interests involved. In addition, payment should be made within a reasonable time of the rendering of the services. It is inequitable for the bank subsidiary to pay fees far in advance in order to suit the parent's cash needs. A clearly understood agreement between the holding company and its bank subsidiaries detailing the duties and responsibilities of each party and the method to be used for fee assessment is also important to the servicing arrangement.

2020.6.3 INSPECTION PROCEDURES

1. Review and analyze the policy regarding management and other services provided to bank subsidiaries and the method of assessing fees.
2. Determine the basis for valuation.
3. Review the actual pricing structure as it is applied.
4. Verify the following:
   a. Fees are charged in accordance with pricing structure.
   b. Pricing structure is consistently applied for all bank subsidiaries.
   c. Bank subsidiaries are actually receiving services for which they are assessed. Determine whether fee payments have caused the institution to become undercapitalized.
   d. Payments are made in a timely manner.
5. Review examination reports on bank subsidiaries for comments on fee assessment.
6. Analyze the parent company's cash flow and income statements for intercompany fees.
7. Review recordkeeping.

A review of management's written or stated policy regarding services provided subsidiaries and fee assessment is a logical starting point for the analysis of this area. The policy should be discussed with the holding company's officers to ensure that the examiner has a clear understanding of the purpose and basic underlying philosophy. Any policy that calls for fee assessment based on standards other than fair market value or the cost of providing the services requires discussion with management and comment on page 1 of the report.

The determination of fair market value or cost of providing services is the responsibility of the holding company. The examiner should review the market or cost information used to justify the pricing of services and be satisfied that the data presented actually supports the fee structure. Request a copy of the pricing schedule as it is applied, and determine that it is actually based on the valuation of the services received and consistent with stated policy. Any variations from the basic structure among the bank subsidiaries would also require support from the market or cost data furnished.

Once the holding company's policy, valuation data, and pricing structure are analyzed, they should be verified. Check the service at the bank-subsidiary level. The verification process can be modified as deemed appropriate by the examiner.

Note the timing of payment for services. Fees for services should be billed and paid as they are received, just as they would be with an unaffiliated servicer. Prepayments are inappropriate in most cases.

Written service agreements should be in effect specifically detailing the types and extent of services being rendered and the method of pricing. Any significant exceptions found during the verification process merit follow-up and comments in the report.

Thus far, these inspection procedures for management and service fees have emphasized a review of management's stated intent and the actual fees charged on the individual bank-subsidiary level and have been somewhat oriented toward micro-level analysis. An overall view of the parent company's cash flow and income statements can also provide certain indicators of appropriateness of fees. The parent company should be servicing its debt and paying dividends from sources other than management fees and service fees collected from bank subsidiaries. If the ratio of management and service fees to parent-company salaries and other expenses significantly exceeds 100 percent, the holding company could be charging fees that are unrelated to the value of the service. This situation would call for further investigation.

2020.6.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Statement of practice and procedure in reference to unsound banking practices; diversion-of-bank-income practices (SR-79-533, March 19, 1979)			4–876	
Potential violations of section 23B of the Federal Reserve Act:				1993 FRB 352
1. Proposal by a bank holding company to provide armored car services to its banking subsidiary through a de novo nonbank subsidiary. The cost of the service would be more than the cost of armored car services currently received from an unaffiliated provider.				
2. Proposal whereby the bank holding company's de novo nonbanking subsidiary would pay a flat fee based on a percentage of its direct operating expenses to cover all the back-office services provided by the holding company's banking subsidiary.				

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The transfer of low-quality assets to an insured depository institution can be reason for supervisory concern. Such transfers may be made to avoid detection and classification during regulatory examinations, and may be accomplished through participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated entities. The donation of an asset with liabilities also is treated as a purchase of assets. An insured depository institution may not purchase a low-quality asset from an affiliate unless, pursuant to an independent credit evaluation, the member bank had committed itself to purchase the asset before the time the asset was acquired by the affiliate. Examiners should be alert to situations where an institution's intention appears to be the concealment of low-quality assets for the purpose of avoiding examination scrutiny and possible classification.

During holding company inspections, examiners should identify situations where low-quality assets have been transferred between the holding company and its subsidiaries and a subsidiary-insured depository institution. Low-quality assets are defined in the Federal Reserve Board's Regulation W (12 CFR 223.3(v)). In general, low-quality assets include assets that are classified or specially mentioned, or if subjected to review would most likely be classified or specially mentioned, including assets classified based on the institution's internal rating system. Low-quality assets also include past due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other asset acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted, if the asset has not yet been reviewed in an examination or inspection. Other assets of questionable quality would include noninvestment grade securities and other real estate owned (OREO). The transfer of assets to avoid supervisory review is a highly improper and unsound banking practice and may be a violation of section 23A of the Federal Reserve Act and the Federal Reserve Board's Regulation W that should be addressed through formal supervisory enforcement action, if necessary.

Any situations involving the transfer of low-quality assets to an insured depository institution should be brought to the attention of Reserve Bank supervisory personnel who, in turn, should notify the local office of the primary federal supervisor(s) of the other depository institution(s) involved in the transaction. For example, Reserve Banks should notify the primary federal supervisor of any depository institution to whom a state member bank or holding company is transferring or has transferred low-quality assets. Reserve Banks also should notify the primary regulator of any depository institution from which a state member bank or holding company is acquiring or has acquired low-quality loans. This procedure applies to transfers involving savings and loan associations and savings banks, as well as commercial banking organizations.

Legitimate transfers of assets should be properly recorded on the books of the acquiring institution at fair market value. If the transfer was with the parent holding company or a nonbank affiliate, determine that the transaction also should be properly recorded on the books of the affiliate.

2020.7.1 INSPECTION OBJECTIVES

1. To ensure that loan transfers involving state member banks, bank holding companies, savings and loan holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification, and to determine the effect of the transfer on the condition of the institution and to ascertain whether the transfer was consistent with the requirements of section 23A. Under section 23A of the Federal Reserve Act, an asset purchase is a "covered transaction." All "covered transactions" by a bank with a single affiliate and with all affiliates combined may not exceed 10 percent and 20 percent, respectively, of a bank's capital and surplus.
2. To ensure that the primary supervisor of the other financial institution involved in the transfer of low-quality assets is notified.

2020.7.2 INSPECTION PROCEDURES

1. Determine whether assets were transferred prior to the date of examination to avoid possible criticism during the examination.
2. Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous examination, or for any other reason were considered to be low-quality assets.

3. Review the institution's policies and procedures to determine whether assets or participations purchased are given an independent, complete and adequate credit evaluation. If a bank is a holding company subsidiary or a member of a chain banking organization, review asset purchases or participations from affiliates or other known members of the organization to determine if the asset purchases are given an arms-length and independent credit evaluation by the purchasing bank.

4. Determine whether any purchases of assets from an affiliate comply with section 23A, which generally prohibits purchases of low-quality assets from an affiliate and limits asset purchases and all other "covered transactions" by a bank from a single affiliate and all affiliates combined to 10 percent and 20 percent, respectively, of a bank's capital and surplus.

5. Determine whether any assets purchased are properly reflected at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such assets and an appropriate risk premium). Determine that appropriate write-offs are taken on any assets sold at less than book value.

6. Determine whether transactions involving transfers of low-quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair value on the books of both the bank and the holding company affiliate.

7. If low-quality assets were transferred to or from another financial institution for which the Federal Reserve is not the primary supervisor, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal supervisor of the other institution involved in the transfer. The memorandum should include the following information, as applicable:

- Name of originating and receiving institutions.
- Type of assets involved and type of transfer (i.e., participation, purchase/sale, swap).
- Date(s) of transfer.
- Total number and dollar amount of assets transferred.
- Status of the assets when transferred (e.g., nonperforming, classified)
- Any other information that would be helpful to the other supervisor.

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. See SR-93-37 and its attachments for further discussion of the Federal Reserve's position on such arrangements between bank holding companies and their subsidiary banks.

2020.9.1 SPLIT-DOLLAR LIFE INSURANCE POLICY ARRANGEMENTS

Certain split-dollar life insurance policy arrangements involving banks and their parent bank holding companies raise legal and safety-and-soundness concerns. These arrangements fall into two general categories: (1) those in which the subsidiary bank owns the policy, pays all or substantially all of the premiums and is reimbursed for the premium payments (if at all) at some time in the future (endorsement plans) and (2) those in which the parent holding company owns the policy, and pays the premium, but uses the insurance policy as collateral for loans from its subsidiary bank (collateral assignment plans).

2020.9.1.1 Split-Dollar Life Insurance Endorsement Plan

Under an endorsement plan, the subsidiary bank purchases a policy in which its parent bank holding company or an officer, director, or principal shareholder thereof is the primary beneficiary, rather than the bank or one of its officers or directors. In this instance, the subsidiary bank receives only a limited portion of the death benefit—usually an amount equal to its premium payments plus interest. The primary beneficiary—the holding company or one of its officers, directors, or principal shareholders—receives a majority of the insurance proceeds but pays little or nothing for the benefit. Many of the policies in this category are single-premium universal life policies, whereby the subsidiary bank pays one large lump sum premium payment for the policy. Generally, a subsidiary bank involved in an endorsement plan records the cash surrender value of the policy as an asset on its books; the bank holding company does not record anything at the parent-only level.

A variation of the endorsement plan is an arrangement in which the bank pays an annual premium towards the policy and the parent holding company reimburses the bank for a nominal amount of the annual premium payments. These amounts are substantially lower than the premium payments made by the subsidiary bank and therefore do not accurately reflect the economic benefit derived by the holding company as primary beneficiary of the insurance policy.

2020.9.1.2 Split-Dollar Life Insurance Collateral Assignment Plan

Under a collateral assignment plan, the parent bank holding company owns the policy and pays the entire premium. The subsidiary bank makes annual loans to the bank holding company in an amount equal to the annual increase in the cash surrender value of the policy (or, in some cases, in amounts equal to premiums paid) with the policy itself serving as collateral for the loan. The loans are repayable at either the termination of employment or the death of the insured employee, and will be paid using the death benefits available from the policy.

2020.9.2 COMPLIANCE WITH APPLICABLE LAWS

2020.9.2.1 Compliance with Sections 23A and 23B of the FRA

Both of the aforementioned types of split-dollar life insurance policy arrangements may be inappropriate if they are inconsistent with sections 23A or 23B of the Federal Reserve Act (FRA). Section 23A places quantitative restrictions and other requirements on certain transactions, including loans, between banks and their affiliates. The statute also requires that loans between banks and their affiliates be secured with collateral having a specified market value that depends on the type of collateral used to secure the loan. Under an endorsement plan, where the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the subsidiary bank to its parent holding company generally results because the subsidiary bank has paid the bank holding company's portion of the premium, and the bank will not be reimbursed fully for its payment until sometime in the future.

Under a collateral assignment plan, if the insurance policy held by the parent bank holding company serves as collateral to secure a loan from its subsidiary bank, the loan may be a violation of section 23A unless it meets the quantitative requirements of section 23A and the cash surrender value of the insurance policy used as security is equal to 130 percent of the amount of the loan. Thus, a bank loan to the parent bank holding company that equals the cash surrender value of the insurance policy that is serving as collateral would not be adequately secured under section 23A, unless additional collateral was provided.

Both categories of split-dollar life insurance policy arrangements may also lead to violations of section 23B of the Federal Reserve Act, which requires that certain transactions involving a bank and its affiliates be on terms and under circumstances substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. Because the bank holding company is the beneficiary of the life insurance policy, it is a participant in a transaction between a bank and a third party; therefore, the split-dollar life insurance transaction must meet the standards of section 23B.[1] In order to conform to the statutory restrictions of section 23B, the return to the bank from ownership of the policy should be commensurate with the size and nature of its financial commitment. In most split-dollar insurance arrangements, the bank makes an investment in the policy not for the purpose of insuring itself against risk but for the purpose of obtaining insurance for its holding company. The only return that the bank will get from its participation in ownership of the policy is the return of its initial investment and possibly some interest. However, the insurance company deducts the cost of maintaining the insurance coverage from interest that would otherwise be credited to the equity in the policy. These costs include policy loads, surrender charges, and mortality costs. The holding company should fully reimburse the bank for all of these charges. Examiners should carefully evaluate these arrangements because, in many cases, the reimbursement the bank receives from the holding company is based on an implied value of the insurance coverage received by the holding company that is less than the assessments made to the policy equity.

In the process of evaluating split-dollar insurance arrangements, examiners should keep in mind the fact that the advances made by a bank to purchase the insurance are the equivalent of a loan to the holding company. Therefore, to comply with section 23B, the terms of the loan, such as its duration and interest rate, must be on market terms.

2020.9.2.2 Investment Authority Under the National Bank Act

Participation by bank holding companies and their state-chartered and national bank subsidiaries in split-dollar life insurance policy arrangements may also raise concerns whether the policies are permissible bank investments under section 24(7) of the National Bank Act. The Office of the Comptroller of the Currency's interpretation of this provision of the National Bank Act (OCC Banking Circular 249, May 9, 1991).[2] In addition, under section 24 to the Federal Deposit Insurance Act, a state-chartered bank generally may not, without the FDIC's permission, engage in any activity that is impermissible for a national bank.[3]

2020.9.3 SAFETY-AND-SOUNDNESS CONCERNS

The purchase of a split-dollar life insurance policy may also constitute an unsafe and unsound banking practice involving the diversion of bank income or assets. If a subsidiary bank pays the entire insurance premium but is not the beneficiary, it provides an economic benefit to its parent holding company or other beneficiary for which it is not being adequately reimbursed or compensated. In this instance, the bank loses the opportunity to use its assets productively. Generally, the bank pays the premium in return for the insurance company's payment of the entire proceeds. When the bank receives less than the entire proceeds, it has, in effect,

1. The Federal Deposit Insurance Corporation has taken the same position in a published interpretive letter, FDIC 92-40, dated June 18, 1992.

2. National banks may not purchase life insurance as an investment. See OCC Banking Circular 249, for the tests under which life insurance may be purchased and held for noninvestment purposes.

3. SR-92-97 (FIS) and SR-92-98 (FIS), dated December 16 and 21, 1992, respectively, describe the provisions of section 24 of the Federal Deposit Insurance Act.

paid a higher than market price for whatever limited benefit it may receive. This is also the case when the primary beneficiary of the policy is an officer, director, or principal shareholder of the parent holding company. Such an arrangement is not consistent with safe and sound banking practices because the subsidiary bank is conferring an economic benefit on an insider of the parent bank holding company without receiving adequate compensation.

2020.9.4 EXAMINER REVIEW OF SPLIT-DOLLAR LIFE INSURANCE

Examiners should be fully aware of the problems inherent in split-dollar life insurance policy arrangements between bank holding companies and their subsidiary banks. During the course of all bank examinations and bank holding company inspections, examiners should review corporate life insurance policy arrangements for compliance with applicable banking laws and safety-and-soundness standards.[4] If a split-dollar life insurance policy arrangement exists in either a bank holding company or a state member bank, it should be reviewed and modified if it does not comply fully with the law and principles of safe and sound banking. If a bank holding company or a state member bank fails to take appropriate action to bring its split-dollar life insurance policy arrangements into compliance, then the Reserve Bank should consider appropriate follow-up supervisory action (including a formal enforcement action) against the banking organization or its institution-affiliated parties, or both.

2020.9.5 INSPECTION OBJECTIVES

1. To determine if split-dollar life insurance arrangements between the parent holding company and its subsidiary banks are consistent with the provisions of sections 23A and 23B of the FRA.

4. Examiners conducting examinations of U.S. branches and agencies of foreign banks and Edge corporations should also be alerted to the problems associated with split-dollar life insurance arrangements because these institutions could purchase insurance for the benefit of a parent foreign bank or company, or one of the parent's officers or directors. In addition, section 7(h) of the International Banking Act of 1978 prohibits state-licensed branches or agencies from engaging in any activity that is impermissible for a federal branch unless the Board determines that such activity is consistent with ''sound banking practice'' and, in the case of an FDIC-insured branch, the FDIC determines that the activity poses no significant risk to the deposit insurance fund.

2. To ascertain whether participation by bank holding companies and their national bank or state-chartered bank subsidiaries is consistent with section 24(7) of the National Bank Act and section 24 of the Federal Deposit Insurance Act.

3. To verify the cash surrender values of split-dollar life insurance policies and to establish whether those values have been impaired by loans to, liens by, or assignments to, third parties or by unauthorized borrowings or cancellations.

2020.9.6 INSPECTION PROCEDURES

1. Review corporate life insurance policy arrangements between the parent company and its subsidiary banks.

   a. Determine if there are split-dollar life insurance arrangements between any subsidiary bank and the parent company or officers or directors of the parent company.

   b. If any such insurance arrangement exists, establish if the plan is either an endorsement plan or a collateral assignment plan.

   c. Review arrangements involving a split-dollar life insurance policy purchased by the parent company.

      (1) Review external documentation evidencing the cash surrender value. If no documentation exists, ask the audit committee and its internal auditors—

         (a) to obtain external documentation verifying its value and

         (b) to verify that there are no outstanding loans, liens, or assignments against the insurance policies.

      (2) Establish whether the parent company's board of directors has established policies and implemented procedures for transactions between the insurance carrier and the parent company to prevent unauthorized borrowing or cancellation of any insurance policy that has a cash surrender value.

      (3) Determine whether the corporate life insurance policy arrangements are consistent with applicable safety-and-soundness standards.

      (4) Verify that the recorded value of the respective asset is equal to the unimpaired cash surrender value of the asset.

2. If an endorsement plan arrangement is purchased by a subsidiary bank, establish whether the bank holding company is the beneficiary. If the parent company is the beneficiary, such an arrangement may result in an unsecured exten-

sion of credit when the subsidiary bank pays all or substantially all of the insurance premiums but is not reimbursed until some time in the future. Ascertain if the investment return to the bank from ownership of the policy is commensurate with the size and nature of its financial commitment.

3. If a collateral assignment plan (when the insurance policy held by the parent company serves as collateral to secure a loan from a subsidiary bank), ascertain whether the cash surrender value of the insurance policy is equal to 130 percent of the amount of the loan.

4. For both types of split-dollar life insurance:

a. Determine if the investment return from ownership of the policy is commensurate with the size and nature of the financial commitment, including all costs incurred for maintaining the insurance coverage.

b. Determine if the terms (duration and market interest rate) of the advances made to purchase the insurance are on market terms.

c. If the bank holding company is the beneficiary of a bank insurance policy and a bank is a participant in the purchase of the insurance from a third party, determine if the transaction was on terms and under circumstances that were substantially the same as or at least as favorable to the bank as those then prevailing for comparable transactions with or involving nonaffiliated companies.

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Split-dollar life insurance:				
1. Endorsement plan: When a subsidiary bank has paid all the BHC's portion of the premium and the bank will not be reimbursed until some time in the future, a loan results that must be secured.	371c, FRA section 23A			
2. Collateral assignment plan securing a loan: Cash surrender value must be 130 percent of the loan.	371c, FRA section 23A			
3. Both plans:				
a. Transactions must be on terms and under circumstances substantially the same as those prevailing for third-party transactions.	371c, FRA section 23B			

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
b. When the BHC is the beneficiary, the bank's investment return from the split-dollar life insurance policy should be commensurate with the size and nature of the financial commitment.	371c-1, FRA section 23B			
Split-dollar life insurance premiums paid by a bank on behalf of an executive officer of the bank are not deemed an extension of credit for purposes of Regulation O, if the officer reported the premiums as taxable compensation to the IRS.			Regulation O staff opinion 3-1081.3	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The history of bank holding company legislation reflects a principle that banking and commerce should be separated in order to prevent abuses in the distribution of credit. The 1956 Act generally required companies to divest their nonbank activities and shares within two years. In the 1970 Amendments, the same requirement applied to companies formed in the future. However, one-bank holding companies in existence at the time of these amendments were given a "grace period" to comply with divestiture requirements of the legislation. Those companies whose bank and nonbank interests had been combined on or before June 30, 1968, were permitted to continue the existing combination for an indefinite period (indefinite or permanent grandfather privileges). But those BHCs which existed at the time of the 1970 Amendments, but whose bank was acquired or whose nonbank activity was initiated after June 30, 1968, were permitted to continue their nonbank activities for only 10 years until December 31, 1980. An exception to the divestiture deadline existed with respect to certain real estate holdings.

Although indefinitely grandfathered companies may continue to engage in nonbanking activities, these grandfather privileges are subject to review by the Federal Reserve Board at the time when a company's banking assets exceed $60 million.[1]

2030.0.1 INDEFINITE GRANDFATHER PRIVILEGES

Under the provisions of section 4(a)(2) of the Act, as amended in 1970, relating to grandfather privileges for certain nonbanking activities of bank holding companies, the Reserve Banks have been delegated the authority to determine that termination of grandfathered activities of a particular bank holding company is not warranted; provided, the Reserve Bank is satisfied that all of the following conditions are met:

1. The company or its successor is "a company covered in 1970;"
2. The nonbanking activities for which indefinite grandfather privileges are being sought do not present any significant unsettled policy issues; and
3. The bank holding company was lawfully engaged in such activities as of June 30, 1968 and has been engaged in such activities continuously thereafter.

A company covered in 1970 is defined in section 2(b) of the Act as "a company which becomes a bank holding company as a result of the enactment of the Bank Holding Company Act Amendments of 1970 and which would have been a bank holding company on June 30, 1968, if those amendments had been enacted on that date." The Board has also determined that the company must have owned at least 25 percent of the voting shares of the same subsidiary bank on June 30, 1968, and December 31, 1970, in order to qualify as a company covered in 1970. If a company was not actively engaged in a nonbank activity prior to June 30, 1968, either directly, or indirectly through a subsidiary, it may still qualify for indefinite grandfather privileges if the company had entered into a binding contract prior to June 30, 1968. The binding contract must be a written document which specifies that the company (or its subsidiary) or persons representing the company will purchase another company which is already engaged in the activity.

Within two years after the subsidiary bank of an indefinitely grandfathered company attains banking assets in excess of $60 million, the status of the company's grandfather privileges is subject to review to determine whether the rights should remain in effect or be terminated. The Board or Reserve Bank may also review any company's grandfather privileges and terminate them if it determines that such action is necessary to prevent (1) undue concentration of resources, (2) decreased or unfair competition, (3) conflicts of interests, or (4) unsound banking practices. Moreover, when a company applies for approval of an acquisition, it may expect the Board or Reserve Bank to review the legitimacy of its grandfather privileges.

2030.0.2 ACTIVITIES AND SECURITIES OF NEW BANK HOLDING COMPANIES

A company that becomes a bank holding company may, for a period of two years, engage in

1. Effective October 20, 1981 the Board amended its Rules Regarding Delegation of Authority to delegate to the Reserve Banks authority to make these determinations regarding indefinite grandfather privileges.

nonbanking activities and control voting securities or assets of a nonbank subsidiary, if the bank holding company engaged in such activities or controlled such voting securities or assets on the date it became a bank holding company. The Board can grant requests for up to three one-year extensions of the two-year period. This is in accordance with a December 1983 revision to Regulation Y (12 C.F.R. 225.22(e)). The regulatory provision implements Section 4(a)(2) of the BHC Act.

2030.0.3 LIMITATIONS ON EXPANSION OF GRANDFATHER RIGHTS FOR INSURANCE AGENCY NONBANKING ACTIVITIES OF BANK HOLDING COMPANIES

Refer to Manual section 3170.0.3.4.1.

2030.0.4 SUCCESSOR RIGHTS

When a bank holding company transfers its bank shares to another company in a manner that produces no substantial change in the control of the bank, the transferee qualifies under section 2(e) of the Act as a "successor." The "successor" provision prevents a bank holding company from transferring its bank to some other organization. A successor is considered a bank holding company from the date the transferor became a bank holding company. Thus, it may hold the same grandfather privileges as its predecessor. By the same token, it becomes subject to any conditions or restrictions, such as divestiture requirements, imposed by the System upon its predecessor. For example, an irrevocable declaration filed by the predecessor would be binding upon the successor.

2030.0.5 EXPANSION OF GRANDFATHER ACTIVITIES

Grandfather privileges apply to activities, not to companies. As a general rule, these activities are permitted to be expanded through internal growth; however, there are a few exceptions. See Appendix 1 in this section.

In Appendix 1 it is important to distinguish between a purchase in the ordinary course of business and a purchase, in whole or in part, of a going concern. Each of the following conditions must be satisfied in order for the transaction to be in the "ordinary course of business," which is permissible: (1) less than a substantial amount of the assets of the company to be acquired must be involved; (2) the operations of the purchased company must not be terminated or substantially discontinued; (3) the assets acquired must not be significant in relation to the size of the same line of nonbank activity already in the holding company (an acquisition is deemed significant if the book value of the acquired nonbank assets exceeds 50 percent of the book value of the nonbank assets of the holding company or nonbank subsidiary comprising the same line of activity); (4) if the transaction involves the acquisition of assets for resale, the sale must be a nominal business activity of the acquiring company; and (5) the major purpose of the transaction must not be to hire essentially all of the seller's principal employees who are expert, skilled and experienced in the business of the company being acquired. If any of these five conditions is not satisfied, the transaction may be considered to be an acquisition of a going concern, which is not permissible without prior approval. Refer to 12 C.F.R. 225.132.

2030.0.6 DIVESTITURES *(also see Manual section 2090.6)*

The act specifies the time in which a company must divest of any impermissible activity. Any company becoming a bank holding company subsequent to the 1970 Amendments has two years in which to divest its impermissible activity. The Act allowed a temporarily grandfathered company ten years from December 31, 1970, to divest of its impermissible activities, except certain real estate holdings discussed earlier; and allows indefinitely grandfathered companies ten years from the date on which grandfather privileges are terminated by the Board or Reserve Bank, should they be terminated for good cause.

As mentioned earlier, reviews of a company's grandfather privileges may be precipitated by such circumstances as: (1) a subsidiary bank of an indefinitely grandfathered company attaining assets in excess of $60 million (reviewed within two years); (2) a company seeking approval to engage in another activity or acquire another bank; (3) a company which violates the Act; or (4) a company operating in a manner which results in an undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

When a company has filed an application requiring the Board's or Reserve Bank's approval, the Board or Reserve Bank may approve the application subject to the condition that the company divest of certain grandfathered shares or assets within a specified time period. The specified time period generally will be shorter than the aforementioned time periods stipulated in the Act.

The plan of divestiture should have provided for the removal of any control relationship between the company and its divested activities. These control requirements, as outlined in section 2(g) of the Act, include one or more of the following: (1) no interlocking directorates; (2) ownership of less than 25 percent of the voting shares by the BHC and related parties; (3) no interlocking management positions in policymaking functions; (4) no indebtedness between the transferor and the transferee; (5) no agreement or understanding which restricts the voting privileges of shares. Further discussion of these and other control requirements and issues is found in Manual sections 2090.1 and 2090.6.

2030.0.7 INSPECTION OBJECTIVES

1. To determine when the company acquired its subsidiary bank.
2. To determine when the company commenced its nonbanking activities and whether these activities were conducted continuously thereafter.
3. To determine if the banking assets of a bank controlled by a holding company with indefinite grandfather privileges have reached \$60 million.
4. To determine if a change of ownership or control of the company has taken place, and whether the transferee qualifies as a ''successor.''
5. To determine if expansions of grandfathered activities occurred in accordance with the Act.

2030.0.8 INSPECTION PROCEDURES

1. If necessary, examine the subsidiary bank's stock certificate book to determine when the company acquired 25 percent or more of the bank.
2. Review the minute books and historical financial records of the company and its subsidiaries for evidence of the date of commencement of any nonbank activity and its continuation thereafter. In particular, the financial records should reflect the activity's impact as either an asset and/or an income item. From these records, also determine whether there has been expansion of the activity and whether such expansion complies with the Act.
3. If necessary, review the latest quarterly Call Report of Condition for the subsidiary bank to determine whether total assets exceeded \$60 million. If appropriate, advise management that its grandfather status is subject to review.
4. If necessary, examine the stock certificate records and minutes of the bank or BHC to determine if the bank's shares have been transferred from one bank holding company to another in such a manner that the transferee qualifies as a successor.
5. Upon review of the aforementioned records, discuss the status of the company's grandfather privileges with the Reserve Bank's management, if necessary.
6. If divestment is required, encourage its execution as soon as possible during the divestment period. Request a divestment plan which specifies the manner by which divestment will be accomplished, the specific steps necessary to effect the divestment, and the time schedule for taking such steps. Advise management that failure to divest within the prescribed time period will be viewed as a violation of the Act.

2030.0.9 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Divestment of activities which are temporarily grandfathered			S-2346 February 15, 1977	
Escrow agreements used in divestiture				1976 FRB 151
Companies with temporarily grandfathered activities encouraged to submit plans by June 30, 1978				1977 FRB 962
Divestment policies	4(a)(2)			1977 FRB 263
Denial of grandfather rights for activities which were shifted from subsidiary bank to nonbank subsidiary				Whitney Holding Corporation, New Orleans, Louisiana; April 27, 1973
Denied continued ownership of a savings and loan association, despite permanent grandfather rights				D.H. Baldwin Company, Cincinnati, Ohio; February 22, 1977
Discussion of indefinite grandfather rights acquired through the indirect power to exercise a controlling influence				Patagonia Corporation, Tucson, Arizona; February 24, 1977
Denial of grandfather rights on additional stock acquired after June 30, 1968, for lack of a controlling influence over the subsidiary as of June 30, 1968				Patagonia Corporation, Tucson, Arizona; July 6, 1973
Successor rights				Republic of Texas Corporation, Dallas, Texas; October 25, 1973

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Interprets "Company covered in 1970" and "Successor"				American Security Corporation, Washington, D.C.; July 21, 1976
Review of grandfather rights as a result of subsidiary bank reaching $60 million in total assets				Colorado Funding Company, Denver, Colorado; September 9, 1977
Review of grandfather rights as a result of subsidiary bank reaching $60 million in total assets—charitable trust involved				General Education Fund, Inc., Burlington, Vermont; September 13, 1977
Companies going out of business are not going concerns				Senate Report 90–1084, page 5524
Failing companies are not going concerns				1974 FRB 725
Ownership of less than 25 percent of a nonbanking company represents an investment rather than a subsidiary				1973 FRB 539
Divestitures		225.138 and 225.140		
Extension of divestiture deadline for real estate interests	Monetary Control Act of 1980 Section 701(b)			
Delegation of authority to Reserve Banks re: Indefinite Grandfathered activities		265.2(f)(42)		1981 FRB 856 and 860

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activities and securities of new bank holding companies		225.22(e)		
Denial of a BHC acquisition—''successor''				1984 FRB 667
Acquisition of assets		225.132		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2030.0.10 APPENDIX 1—EXPANSION OF GRANDFATHERED ACTIVITIES

Permissible Type of Expansion	*Without Approval*	*Requires Approval*
FOR COMPANIES WITH AN INDEFINITELY GRANDFATHERED NONBANK ACTIVITY		
1. Opening of additional offices of existing subsidiary	X	
2. Acquisition of assets in the ''ordinary course of business'' as defined	X	
3. Acquisition of a going concern:		
a. Additional shares of the grandfathered nonbanking subsidiary	X	
b. Additional shares of a nonbanking company which is regarded as an investment (generally companies in which the holding company has an interest of between 5 and 25 percent)		X
c. Initial acquisition of shares of any other company engaging in the activity		X

Commitments to the Board arise most often through the application process. Many commitments are included within the text of accompanying Board orders or letters transmitted to the applicants. Commitments can also arise through the supervisory process. Commitments should be specific and furnished in written form.

The most common type involves a commitment to inject capital (either equity or debt capital) into the company or subsidiary to be acquired or possibly into other subsidiaries of the bank holding company. The required injections may be for a specific dollar amount or for an unspecified amount necessary to achieve a predetermined capital relationship. Determining compliance with such commitments is generally not difficult since an agreed upon quantifiable result must be achieved.

Types of commitments made to the Board in the past include: divestiture of nonpermissible stock holdings or activities; introduction of new services; and reduction or elimination of dividends or management fees from subsidiaries.

Several of the above forms of commitments are rather difficult to monitor due to their inexact nature. The examiner should determine in such cases whether good faith compliance efforts have been made. Where an order approving an application imposes specific conditions, however, compliance is of the utmost importance since a conditional order is based on the theory that such conditions were necessary to eliminate or outweigh adverse factors. Willful noncompliance in these cases might necessitate the use of cease-and-desist powers to prevent evasion of the purposes of the Act. Pursuant to the Board's request, each Reserve Bank reports semi-annually on the status of all outstanding commitments made by holding companies in its District.

2040.0.1 INSPECTION OBJECTIVES

1. To determine that the bank holding company is taking the necessary steps to fulfill any outstanding commitments as scheduled.
2. To determine whether additional commitments or conditions should be imposed to achieve complete compliance.
3. To determine whether a request for an extension of time to fulfill any outstanding commitment is warranted.

2040.0.2 INSPECTION PROCEDURES

1. Review semi-annual commitment reports to the Board for commitments fulfilled since the last inspection. Determine whether such commitments were completed as required.
2. Review with management any actions taken to comply with outstanding commitments or plans to effect fulfillment.
3. If warranted, initiate action to consider an extension for compliance on outstanding commitments.

WHAT'S NEW IN THIS REVISED SECTION

This section was updated to discuss amendments to the Federal Reserve Act regarding insider lending. The definition of "extension of credit" was revised to include an insured depository institution's (IDI) credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. See the Federal Reserve Act, section 22(h)(9)(D)(i), as amended by the Dodd-Frank Act, section 614(a).

The Federal Deposit Insurance Act was amended to prohibit the purchase or sale of assets between an IDI and an executive officer, director, or principal shareholder of the IDI, and any related interest of such person, unless the transaction is on market terms. In addition, if the asset purchase or sale represents more than 10 percent of the IDI's capital stock and surplus, the transaction must be approved in advance by a majority of the members of the board of directors of the IDI who do not have an interest in the transaction. See section 615(1) of the Dodd-Frank Act.

2050.0.1 BHC OFFICIAL AND RELATED INTEREST TRANSACTIONS BETWEEN THE PARENT COMPANY OR ITS NONBANK SUBSIDIARIES

Business transactions between a parent bank holding company or its nonbank subsidiary and a BHC official or a BHC official's related interests require close supervisory review. "Bank holding company official" is defined as any director, executive officer, or principal shareholder of the parent company or any of its subsidiaries, excluding the subsidiary bank's nonbank subsidiaries.

Most of these transactions are soundly structured and have a legitimate business purpose that result in equitable treatment for all parties. However, examiners should pay close attention to all extensions of credit by a BHC or its nonbank subsidiary to a BHC official or related interest to ensure that the terms of the credit, particularly interest-rate and collateral terms, are not preferential and that the credit does not involve more than a normal risk of repayment.

An extension of credit by a BHC or nonbank subsidiary may be considered abusive or self-serving if its terms are unfavorable to the lender, or if the credit would not have been extended on the same terms absent the official relationship; that is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist. When a transaction appears questionable, a complete inquiry into the facts and circumstances should be undertaken so that a legal determination can be obtained.

In addition to the above supervisory considerations, the Sarbanes-Oxley Act of 2002 (Pub. L. No. 107-204) (the act) imposed certain insider lending restrictions on public companies, including BHCs that are public companies. A BHC generally is considered a public company for these purposes if it has a class of securities registered under section 12 of the Securities Exchange Act of 1934 (the 1934 act) or is required to file reports with the Securities and Exchange Commission (SEC) under section 15 of the 1934 act. The Sarbanes-Oxley Act[1] prohibits a publicly owned BHC (public BHC) and its subsidiaries from extending credit, or arranging for another entity to extend credit, in the form of a personal loan to any director or executive officer of the public BHC.[2] This prohibition does not apply to any extension of credit made before July 30, 2002, so long as the loan is not renewed or materially modified after that date.

The Sarbanes-Oxley Act includes two exceptions to this loan prohibition. First and most importantly, the prohibition does not apply to any loan made by an insured depository institution that is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act, as implemented by the Board's Regulation O. Thus, loans by the insured depository institution subsidiaries of a public BHC to a director or executive officer of the BHC likely are exempt from the prohibition, although they would be subject to Regulation O as discussed below. The second exception permits the directors and executive officers of a public BHC to obtain home improvement and manufactured home loans, consumer loans, and loans under open-end credit plans or charge cards from the public BHC or its subsidiaries, so long as the

1. See 15 U.S.C. 78m (section 402 of the act).

2. The act does not restrict lending by a subsidiary of a public BHC to the subsidiary's own directors and executive officers, so long as these persons are not also directors or executive officers of the public BHC.

credit (1) is extended in the ordinary course of the company's consumer credit business, (2) is a kind of credit generally made available to the public, and (3) is made on market terms or on terms that are no more favorable than those offered to the general public.

2050.0.2 TRANSACTIONS INVOLVING OTHER PROPERTY OR SERVICES

Other transactions involving BHC officials, their related interests, and the BHC and nonbank subsidiary that should be reviewed by the examiner include the—

1. purchase of assets or services from the BHC or nonbank subsidiary, particularly if at a discount or on preferential terms;
2. sale of assets or services to the BHC or nonbank subsidiary, particularly if at a premium;
3. lease of property to or from the BHC or nonbank subsidiary; and
4. use of BHC or nonbank subsidiary property or personnel by a BHC official or related interest.

As with loans and other extensions of credit to BHC officials on preferential terms, abusive or self-serving insider transactions involving other property or services deprive the BHC or nonbank subsidiary of higher returns or gains that may have been achieved had the same transaction been at a fair market price. A fair market price would be that price charged or received from an unaffiliated party.

The Dodd-Frank Act amended the Federal Deposit Insurance Act (FDIA) to impose a prohibition on asset purchases and between an IDI and an executive officer, director, or principal shareholder of the IDI, and any related interest of such person, unless the transaction is on market terms. In addition, if the asset purchase or sale represents more than 10 percent of the IDI's capital stock and surplus, the transaction must be approved in advance by a majority of the members of the board of directors of the IDI who do not have an interest in the transaction. See section 18(z) of the FDIA, as amended by the Dodd-Frank Act, section 615(a).

A fair market price is often difficult to determine because the assets or services involved may be unique to a given situation and individuals. In general, the fair market price of even unique assets or services can be approximated by the cost of the assets or services to the party selling or furnishing them, if appropriate. The value of services or properties provided by a BHC or nonbank subsidiary should be established and justified either by policy or on a case-by-case basis, and appropriate documentation should be available to the examiner.

Services provided by a BHC official or a related interest to a BHC or nonbank subsidiary, while not unusual, may be most difficult to value. In part because of the problem of valuation, this type of transaction is among the most susceptible to abuse. The cost of providing services is frequently derived by placing value on the time of the individuals providing the services. When services are provided by a BHC official who normally places a very high billing value on time provided, the benefits to the BHC must be assessed in order to form a basis for determining a fair price. The BHC official may be a highly regarded professional whose time and services have great value to the organization. However, when the BHC requires routine clerical services, officials should not charge the BHC a professional-level rate for such services. Under these or similar circumstances, the BHC would be considered imprudent in paying such rates and could be subject to critical comment.

2050.0.3 REGULATION O

For ease of reference, certain Regulation O definitions and limitations, as revised by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), are presented here, some in abbreviated form. A thorough review of the entire regulation (found at FRRS 3–960), and the Board's press releases pertaining to Regulation O, is necessary for a complete understanding of the regulation. (Note that section 108 of the Financial Institutions Regulatory Act of 1978 amended section 18(j) of the Federal Deposit Insurance Act to make section 22(h) of the Federal Reserve Act applicable to nonmember insured banks.)

Purpose of Regulation O. Regulation O governs any extension of credit by a member bank and its subsidiaries (based on amendments contained in FDICIA, Regulation O also applies to nonmember insured depository institutions) to an executive officer, director, or principal shareholder of (1) the member bank, (2) a bank holding company of which the member bank is a subsidiary, and (3) any other subsidiary of that bank holding company. It also applies to any extension of credit by a member bank to (1) a company controlled by such a person and (2) a political or campaign committee that benefits or is controlled by such a person.

Supervision of BHCs and their nonbank subsidiaries. Regulation O deals exclusively with extensions of credit by banks and their subsidiaries, not extensions of credit by BHCs and their nonbank subsidiaries. However, because the regulations curtail or eliminate abusive transactions, they can be used as a guide or model in providing standards for the supervisory review of extensions of credit by BHCs and nonbank subsidiaries. Although a direct extension of credit by a BHC could not be determined to be a *violation* of Regulation O, if the credit fails to meet the requirements that Regulation O establishes for banks, it may be possible to conclude that the BHC is engaging in either an unsafe or unsound practice that exposes the entire banking organization to undue risk and exposure to loss. Regulation O limits credit extensions by a bank to officials of that bank and their related interests; therefore, examiners should be especially alert to credit extensions from BHCs and nonbank subsidiaries. If credit extensions appear to circumvent the intent of Regulation O, they should be identified and discussed with management and noted in the inspection report for follow-up review and possible formal corrective action by regulatory authorities.

2050.0.3.1 FDICIA and BHC Inspection Guidance for Regulation O

On April 22, 1992, the Board adopted amendments to Regulation O, effective May 18, 1992, to implement the changes required by section 306 of FDICIA. Section 306 amended section 22(h) of the Federal Reserve Act and replaced the language of section 22(h) with the provisions of the Board's Regulation O. Section 306 also made several substantive modifications to section 22(h) that required revisions to Regulation O. These changes are outlined in the Board's press release and *Federal Register* notice of May 28, 1992 (57 *Fed. Reg.* 22,417).

The following are some of the more significant changes that were made effective May 18, 1992:[2a]

1. *Aggregate lending limit (section 215.4(d)).* The aggregate limit on the total amount that a bank can lend to its insiders and their related interests as a class was changed. In general, this amount is equal to the bank's unimpaired capital and unimpaired surplus. The Board also decided as a one-year interim measure to permit banks with deposits under $100 million to adopt a higher limit, not to exceed 200 percent of the bank's unimpaired capital and unimpaired surplus. (This interim period was extended twice by the Board, extending the higher limit through February 18, 1994, when the higher limit became permanent. The board of directors must provide an annual resolution authorizing the use of this higher limit. Other conditions also apply.)
2. *Lending limits for directors and related interests (section 215.4(c)).* Loans to directors (and their related interests) are subject to the same lending limit that is applicable to executive officers and principal shareholders (and their related interests).
3. *Credit standards (section 215.4(a)).* When lending to an insider[2b] a bank must follow credit underwriting procedures that are as stringent as those applicable to comparable transactions by the bank with persons outside the bank.
4. *Definition of "principal shareholder" (section 215.2(m)(1)).* The definition of *principal shareholder* was tightened for banks located in small communities. The previously existing 10 percent limitation was made applicable to all banks, regardless of the size of the communities in which they were located.[3]
5. *Definition of "member bank" (section 215.2(j)).* The term *member bank* was redefined to include any subsidiary of the member bank. This revision clarified that an extension of credit from a subsidiary of a member bank is subject

2a. The Regulation O cites are to the February 18, 1994, amendment.

2b. The term *insider* refers to an executive officer, director, or principal shareholder, and includes any related interest of such a person.

3. The Board amended the definition of *principal shareholder of a member bank,* effective December 17, 1992, so that it does not include a company of which a member bank is a subsidiary. This amendment excludes from Regulation O loans to a company that owns, controls, or exercises a controlling influence over a member bank, as those relationships are defined in section 2(d) of the Bank Holding Company Act, as well as the related interests of such a parent bank holding company. The definition of *principal shareholder* for purposes of reporting obligations under section 215.11 of Regulation O was not changed as a result of the Housing and Community Development Act of 1992 because those portions of Regulation O implement provisions of law in addition to section 22(h) of the Federal Reserve Act.

to the same insider restrictions as an extension of credit from a member bank itself.

6. *Coverage of all companies that own banks (section 215.2(b)).* All companies that own banks became subject to Regulation O, regardless of whether they are technically bank holding companies.

7. *Prohibition on knowingly receiving unauthorized extensions of credit (section 215.6).* Insiders are prohibited from knowingly receiving (or permitting their related interests to receive) any extension of credit not authorized by section 22(h) of the Federal Reserve Act.

8. *Reporting requirement for certain credit (section 215.12).* Executive officers and directors of member banks that do not have publicly traded stock are required to report annually to their institutions the outstanding amount of any credit secured by shares of the insider's institution.

In a February 18, 1994, press release, the Federal Reserve Board announced its approval of a final rule that further amended several provisions of Regulation O, effective on that date. Some of the provisions carried out or further refined provisions of FDICIA. The amendments were designed to increase the ability of banks to make extensions of credit that pose minimal risk of loss, to eliminate recordkeeping requirements that impose a paperwork burden, and to remove certain transactions from the regulation's coverage consistent with bank safety and soundness. The amendments were expected to increase the availability of credit, particularly in communities served by small banks. The following is a discussion of some of the rule's primary provisions.

1. *Aggregate lending limit—exception for small, adequately capitalized banks (section 215.4(d)).* This revision of Regulation O made permanent an interim rule increasing the aggregate lending limit for small, adequately capitalized banks from 100 percent of the bank's unimpaired capital surplus to 200 percent, provided the bank satisfies three conditional criteria.

2. *Exceptions to the general limits on lending (section 215.4(d)(3)).* The Board adopted certain exceptions to the general restrictions on lending to insiders. The exceptions apply to loans fully secured by—

a. obligations of the United States or other obligations fully guaranteed as to principal and interest by the United States;

b. commitments or guarantees of a department or agency of the United States; or

c. a segregated deposit account with the lending bank.

An exception is also made for loans arising from the discount of installment consumer paper by an insider with full or partial recourse endorsement or guarantee by the insider, if the maker of the paper is not an insider and the loan was made relying primarily on the maker and this is properly documented. Such loans continue to be subject to the prohibitions against preferential lending.

3. *Including closing costs in the refinancing of home mortgage loans (section 215.5(c)(2)).* Section 22(g) of the Federal Reserve Act allows a bank to make a loan to its executive officer, without restrictions on the amount, if the loan is secured by a first lien on a dwelling that is owned and used by the executive officer as a residence after the loan is made. The Board's amendment includes the refinancing of home mortgage loans in this category only if the proceeds are used to pay off the previous home mortgage loan or for the other purposes listed in this section. The regulation states that closing costs can be included as part of the exempt portion of a home mortgage refinancing.

4. *Alternative recordkeeping procedures (section 215.8).* Banks are permitted to follow alternative recordkeeping procedures on loans to insiders of affiliates. The amendment allows a bank to decide on its own how to gather information on related interests, so long as its method is effective. For example, a nonbank credit card bank or other bank that does not make commercial loans could decide not to keep records on related interests. For banks that make commercial loans, one of two acceptable methods is required, unless a bank can demonstrate that another method is equally effective: (a) the "survey" method or (b) the "borrower inquiry" method. Every bank, regardless of the recordkeeping method it selects, must conduct an annual survey to identify *its own insiders*, but not those of its holding company affiliates. Every bank is expected to check this short list before extending credit, even if it is using the borrower-inquiry method of recordkeeping for affiliates in lieu of the survey method.

5. *Tangible-economic-benefit rule (section 215.3(f)).* This rule was similar to a provision in section 23A of the Federal Reserve Act and was adopted at a time when the Board was required by section 22(h) of the Federal Reserve Act to use the definition of "extension of credit" found in section 23A. However, the definition of extension of credit in section 22(h) is no longer

tied to section 23A. The Board has therefore revised the tangible-economic-benefit rule to clarify that it does not reach certain transactions that may benefit an insider. The Board explicitly provided that the rule does not apply to an arm's-length extension of credit by a bank to a third party where the proceeds of the credit are used to finance the bona fide acquisition of property, goods, or services from an insider or an insider's related interest.

2050.0.3.2 Definitions in Regulation O (abbreviated listing)

Note: Regulation O definitions, prohibitions, exceptions, and exemptions are particularly detailed and complex. Therefore, inspection staff should consult with Reserve Bank or Board supervisory or legal staff before discussing with management or presenting in an inspection report any BHC inspection findings that rely upon Regulation O.

(a) "Affiliate" means any company of which a member bank is a subsidiary or any other subsidiary of that company.

(b) "Company" means any corporation, partnership, trust (business or otherwise), association, joint venture, pool syndicate, sole proprietorship, unincorporated organization, or any other form of business entity. The term, however, does not include (1) an insured bank (as defined in 12 U.S.C. 1813) or (2) a corporation the majority of the shares of which are owned by the United States or by any state.

(c)(1) "Control of a company or bank" means that a person directly or indirectly, or acting through or in concert with one or more persons (i) owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the company or bank; (ii) controls in any manner the election of a majority of the directors of the company or bank; or (iii) has the power to exercise a controlling influence over the management or policies of the company or bank. (Note: If a company does not have voting securities (that is, a partnership), review the degree of interest in the company to determine control.)

(2) A person is presumed to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank if (i) the person is an executive officer or director of the company or bank and directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank or (ii) the person directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank, and no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

(3) An individual is not considered to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank solely by virtue of the individual's position as an officer or director of the company or bank.

(d) "Director" of a company or bank means any director of the company or bank, whether or not receiving compensation.[3a] An advisory director is not considered a director if the advisory director (1) is not elected by the shareholders of the bank or company, (2) is not authorized to vote on matters before the board of directors, and (3) provides solely general policy advice to the board of directors.

(e)(1) "Executive officer" of a company or bank means a person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank, whether or not the officer has an official title; the title designates the officer an assistant; or the officer is serving without salary or other compensation.[4]

3a. Extensions of credit to a director of an affiliate of a bank are not subject to the general prohibitions (section 215.4), the prohibitions on knowingly receiving unauthorized extensions of credit (section 215.6), and the alternative recordkeeping procedures (section 215.8) if—

(1) the director of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, and the director does not actually participate in those functions;

(2) the affiliate does not control the bank; and

(3) as determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that controls the bank and is not controlled by any other company, and the director of the affiliate is not otherwise subject to sections 215.4, 215.6, and 215.8 of Regulation O.

If the director of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, a resolution of the board of directors or a corporate bylaw may (1) include the director (by name or by title) in a list of persons excluded from participation in such functions or (2) not include the director in a list of persons authorized (by name or by title) to participate in such functions.

4. The term "executive officer" is not intended to include persons who may have official titles and may exercise a certain measure of discretion in the performance of their duties, including discretion in the making of loans, but who do not participate in determining major policies of the bank or company and whose decisions are limited by policy standards

The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a company or bank are considered executive officers, unless the officer is excluded, by resolution of the board of directors or by the bylaws of the bank or company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company, and the officer does not actually participate therein.

(2) Extensions of credit to an executive officer of an affiliate of a member bank (other than a company that controls the bank) are not subject to sections 215.4, 215.6, and 215.8 of Regulation O if—

(i) the executive officer of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, and the executive officer does not actually participate in those functions;

(ii) the affiliate does not control the bank; and

(iii) as determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that controls the bank and is not controlled by any other company, and the executive officer of the affiliate is not otherwise subject to sections 215.4, 215.6, and 215.8 of Regulation O.

If the executive officer of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, a resolution of the board of directors or a corporate bylaw may (i) include the executive officer (by name or by title) in a list of persons excluded from participation in such functions or (ii) not include the executive officer in a list of persons authorized (by name or by title) to participate in such functions.

(f) "Immediate family" means the spouse of an individual, the individual's minor children, and any of the individual's children (including adults) residing in the individual's home.

(g) "Insider" means an executive officer, director, principal shareholder, and any related interest of such person.

(h) The "lending limit" for a member bank is an amount equal to the limit on loans to a single borrower established by section 5200 of the Revised Statutes,[5] 12 U.S.C. 84. This amount is 15 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are not fully secured, and an additional 10 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the loan. The lending limit also includes any higher amounts that are permitted by section 5200 of the Revised Statutes for the types of obligations listed therein as exceptions to the limit.

A member bank's *unimpaired capital* and *unimpaired surplus* equals the (1) member bank's tier 1 and tier 2 capital included in the bank's risk-based capital, under the capital guidelines of the appropriate federal banking agency, and (2) balance of the member bank's allowance for loan and lease losses that was not included in the bank's tier 2 capital. This computation is based on the bank's risk-based capital under the capital guidelines of the appropriate federal banking agency, based on the bank's most recent consolidated report of condition filed under 12 U.S.C. 1817(a)(3).

(i) "Member bank" means any banking institution that is a member of the Federal Reserve System, including any subsidiary of a member bank. The term does not include any foreign bank that maintains a branch in the United States, whether or not the branch is insured (within the meaning of 12 U.S.C. 1813(s)) and regardless of the operation of 12 U.S.C. 1813(h) and 12 U.S.C. 1828(j)(3)(B).

(j) "Person" means an individual or a company.

(k) "Principal shareholder"[6] means an individual or a company (other than an insured bank) that directly or indirectly, or acting through or in concert with one or more persons,

fixed by the senior management of the bank or company. For example, the term does not include a manager or assistant manager of a branch of a bank unless that individual participates, or is authorized to participate, in major policymaking functions of the bank or company.

5. Where state law establishes a lending limit for a state member bank that is lower than the amount permitted in section 5200 of the Revised Statutes, the lending limit established by the applicable state laws shall be the lending limit for the state member bank.

6. On October 28, 1992, in section 955 of the Housing and Community Development Act of 1992, Congress amended section 22(h) of the Federal Reserve Act to exclude from the definition of *principal shareholder* a company of which a member bank is a subsidiary. Regulation O was amended, effective December 17, 1992, to implement this change. As a result of the amendment, extensions of credit by a bank to its holding company and to any related interests of its subsidiary are governed solely by sections 23A and 23B of the Federal Reserve Act.

owns, controls, or has the power to vote more than 10 percent of any class of voting securities of a member bank or company. Shares owned or controlled by a member of an individual's immediate family are considered to be held by the individual. A principal shareholder of a member bank includes (1) a principal shareholder of a company of which the member bank is a subsidiary and (2) a principal shareholder of any other subsidiary of that company, exclusive of nonbank subsidiaries of member banks.

(*l*) "Related interest" means (1) a company that is controlled by a person or (2) a political or campaign committee that is controlled by a person or the funds or services of which will benefit a person.

(m) "Subsidiary" has the meaning given in section 2(d) of the BHC Act, but does not include a subsidiary of a member bank.

2050.0.3.2.1 Extension of Credit

For the purposes of Regulation O, an "extension of credit" is

(a) a making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever and includes:

(1) a purchase under repurchase agreement of securities, other assets, or obligations;

(2) an advance by means of an overdraft, cash item, or otherwise;

(3) issuance of a standby letter of credit (or other similar arrangement regardless of name or description) or an ineligible acceptance;

(4) an acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;

(5) an increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (i) accrued interest or (ii) taxes, insurance, or other expenses incidental to the existing indebtedness;

(6) an advance of unearned salary or other unearned compensation for a period in excess of 30 days; and

(7) any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

The Dodd-Frank Act added to the definition of an "extension of credit" an insured depository institution's (IDI) credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction.

An extension of credit *does not* include—

(1) an advance against accrued salary or other accrued compensation, or an advance for the payment of authorized travel or other expenses incurred or to be incurred on behalf of the bank;

(2) a receipt by a bank of a check deposited in or delivered to the bank in the usual course of business unless it results in the carrying of a cash item for or the granting of an overdraft (other than an inadvertent overdraft in a limited amount that is promptly repaid under terms that are not more favorable than those offered to the general public).

(3) an acquisition of a note, draft, bill of exchange, or other evidence of indebtedness through (i) a merger or consolidation of banks or a similar transaction by which a bank acquires assets and assumes liabilities of another bank or similar organization or (ii) foreclosure on collateral or similar proceeding for the protection of the bank, provided that such indebtedness is not held for a period of more than three years from the date of the acquisition, subject to

extension by the appropriate federal banking agency for good cause;

(4)(i) an endorsement or guarantee for the protection of a bank of any loan or other asset previously acquired by the bank in good faith or (ii) any indebtedness to a bank for the purpose of protecting the bank against loss or of giving financial assistance to it;

(5) indebtedness of $15,000 or less arising by reason of any general arrangement by which a bank (i) acquires charge or time credit accounts or (ii) makes payments to or on behalf of participants in a bank credit card plan, check credit plan, or similar open-end credit plan, provided—

(A) the indebtedness does not involve prior individual clearance or approval by the bank other than for the purposes of determining authority to participate in the arrangement and compliance with any dollar limit under the arrangement and

(B) the indebtedness is incurred under terms that are not more favorable than those offered to the general public;

(6) indebtedness of $5,000 or less arising by reason of an interest-bearing overdraft credit plan (see Regulation O, section 215.4(e)); or

(7) a discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, without recourse.

Non-interest-bearing deposits to the credit of a bank are not considered loans, advances, or extensions of credit to the bank of deposit. Also, the giving of immediate credit to a bank upon collected items received in the ordinary course of business is not considered to be a loan, advance, or extension of credit to the depositing bank.

An extension of credit by a member bank (for the purposes of section 215.4 of Regulation O) is considered to have been made at the time the bank enters into a binding commitment to make the extension of credit. A participation without recourse is considered to be an extension of credit by the participating bank, not by the originating bank.

Tangible-economic-benefit rule. In general, an extension of credit is considered made to an insider to the extent that the proceeds are transferred to the insider or are used for the tangible economic benefit of the insider. An extension of credit is not considered made to an insider if—

(1) the credit is extended on terms that would satisfy the standard set forth in section 215.4(a) of Regulation O for extensions of credit to insiders and

(2) the proceeds of the extension of credit are used in a bona fide transaction to acquire property, goods, or services from the insider.

2050.0.3.2.2 Insider Use of a Bank-Owned Credit Card

Board staff issued a May 22, 2006, legal opinion in response to an FDIC request for clarification on the application of the Board's Regulation O (12 C.F.R. 215) to credit cards that are issued to bank insiders for the bank's business purposes.[7] The FDIC asked whether, and under what circumstances, an insider's use of a bank-owned credit card would be deemed an extension of credit by the bank to the insider for purposes of Regulation O.

The FDIC indicated that insiders of a bank often use a bank-owned credit card to purchase goods and services for the bank's business purposes. A bank-owned credit card is a credit card that is issued by a third-party financial institution to a bank to enable the bank (through its employees) to finance the purchase of goods and services for the bank's business. Board staff commented that it was understood that (1) a bank that provides a bank-owned credit card to its employees typically forbids or discourages use of the card by employees for their personal purposes and that an employee who uses the card for personal purposes is obligated to promptly reimburse the bank and (2) a bank is liable to the card-issuing institution for all extensions of credit made under the card (whether for the bank's business purposes or for an employee's personal purposes)[8].

Although section 215.3(a) of Regulation O broadly defines an extension of credit to include "a making or renewal of a loan, a granting of a line of credit, or an extending of credit in any manner whatsoever," the rule also provides several important exceptions to the definition that are relevant to the FDIC's inquiry. Section 215.3(b)(1) of Regulation O excludes from the

7. The provisions of Regulation O apply to a bank holding company of which a member bank is a subsidiary, and any other subsidiary of that bank holding company. (See 2050.0.3.)

8. In the responding letter, Board legal staff notes that it was understood that some banks directly issue credit cards to their employees to enable the employees to finance the purchase of goods and services for the bank's business (bank-issued credit cards). Also, the letter states that the principles set forth with regard to bank-owned credit cards also would apply to bank-issued credit cards.

definition of extension of credit any advance by a bank to an insider for the payment of authorized or other expenses incurred or to be incurred on behalf of the bank. Also, section 215.3(b)(5) of Regulation O excludes from the definition of extension of credit indebtedness of up to $15,000 incurred by an insider with a bank under an ordinary credit card.

Considering the provisions of Regulation O and the purposes of the insider lending restrictions in the Federal Reserve Act, Board legal staff opined that a bank does not make an extension of credit to an insider for purposes of Regulation O at the time of issuance of a bank-owned credit card to the insider (regardless of whether the line of credit associated with the card is greater than $15,000). The opinion states also that a bank does not extend credit to an insider for the purposes of Regulation O when the insider uses the card to purchase goods or services for the bank's business purposes. However, when an insider uses the card to purchase goods or services for the insider's personal purposes, the bank may be making an extension of credit to the insider. The opinion states that an extension of credit would occur for the purposes of Regulation O if—and to the extent that—the amount of outstanding personal charges made to the card, when aggregated with all other indebtedness of the insider that qualifies for the credit card exception in section 215.3(b)(5) of Regulation O, exceeds $15,000.

The FDIC also asked whether incidental personal expenses charged by an insider to a bank-owned credit card are per se violations of the market-terms requirement in section 215.4(a) of Regulation O because non-insiders do not have access to this form of credit from the bank. In response, Board staff stated that section 215.4(a) requires extensions of credit by a bank to its insiders to (1) be on substantially the same terms (including interest rates and collateral) as, and subject to credit underwriting standards that are not less stringent than, those prevailing at the time for comparable transactions with non-insiders and (2) not involve more than the normal risk of repayment or other features unfavorable to the bank.

The opinion states that a bank may be able to satisfy the market-terms requirement, however, if the bank approves an insider for use of a bank-owned credit card only (1) if the insider meets the bank's normal credit underwriting standards and (2) the card does not have preferential terms (or the card does not have preferential terms in connection with uses of the card for personal purposes). Nonetheless, use of a bank-owned credit card by an insider for personal purposes may violate the market- terms requirement of Regulation O if the card carries a lower interest rate or permits a longer repayment period than comparable consumer credit offered by the bank.

The Board staff's legal opinion applies only to the specific issues and circumstances described in the letter and does not address any other issues or circumstances.

2050.0.3.3 General Prohibitions and Limitations of Regulation O

(a) *Terms and creditworthiness.* No member bank may extend credit to any insider of the bank or insider of its affiliates unless the extension of credit (1) is made on substantially the same terms (including interest rates and collateral) as, and following credit-underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not covered by Regulation O and who are not employed by the bank and (2) does not involve more than the normal risk of repayment or present other unfavorable features.

Nothing stated above (as to ''terms and creditworthiness'') should prohibit any extension of credit made in accordance with a benefit or compensation program that—

1. is widely available to employees of the member bank, and in the case of extensions of credit to an insider of its affiliates, is widely available to employees of the affiliates at which that person is an insider and
2. does not give preference to any insider of the member bank over other employees of the member bank and, in the case of extensions of credit to an insider of its affiliates, does not give preference to any insider of its affiliates over other employees of the affiliates of which that person is an insider.

(b) *Prior approval.* A member bank may not extend credit (including granting a line of credit) to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit to that person and to all related interests of that person, exceeds the higher of $25,000 or 5 percent of the member bank's unimpaired capital and unimpaired surplus, but in no event can it exceed $500,000. This provision applies unless (1) the extension of credit or line of credit has been approved in advance by a majority of the entire board of directors of that bank and (2) the interested party has abstained from participating directly or indirectly in the voting.

The board of directors' approval is not required for an extension of credit that is made pursuant to a line of credit that was approved by the board of directors within 14 months of the date of the extension of credit. Participation in the discussion, or any attempt to influence the voting, by the board of directors regarding an extension of credit constitutes indirect participation in the voting by the board of directors on an extension of credit.

(c) *Individual lending limit*. A member bank may not extend credit to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit by the member bank to that person and to all related interests of that person, exceeds the lending limit described above in section 2050.0.3.2 (paragraph h). This prohibition does not apply to an extension of credit by a member bank to a company of which the member bank is a subsidiary or to any other subsidiary of that company.

(d) *Aggregate lending limit.*

(1) *General limit*. A member bank may not extend credit to any insider of the bank or insider of its affiliates unless the extension of credit is in an amount that, when aggregated with all outstanding extensions of credit to all such insiders, would exceed the bank's unimpaired capital and unimpaired surplus as defined in section 215.2(i) of Regulation O (see section 2050.0.3.2, paragraph h).

(2) A member bank with deposits of less than $100,000,000 may, by an annual resolution of its board of directors, increase the general limit (specified above) to a level that does not exceed two times the bank's unimpaired capital and unimpaired surplus if the board of directors determines that such higher limit is consistent with prudent, safe, and sound banking practices in light of the bank's experience in lending to its insiders and is necessary to attract or retain directors or to prevent the restriction of the availability of credit in small communities.

The board of directors' resolution must set forth the facts and reasoning on which it bases its finding, including the amount of the bank's lending to its insiders as a percentage of the bank's unimpaired capital and unimpaired surplus as of the date of the resolution. In addition, the bank must meet or exceed, on a fully phased-in basis, all applicable capital requirements established by the appropriate federal banking agency. The bank would also have had to receive a satisfactory composite rating in its most recent bank examination report.

If a member bank has adopted a resolution authorizing a higher limit and subsequently fails to meet the above-listed requirements, the member bank cannot extend any additional credit (including a renewal of any existing extension of credit) to any insider of the bank or its affiliates unless the extension or renewal is consistent with the general limit.

(3) *Exceptions to the general limit.* Effective May 3, 1993, the general limit, described in manual section 2050.0.3.3 (paragraph d) and specified in section 215.4(d)(1) of the Board's Regulation O does not apply to—

(i) extensions of credit secured by a perfected security interest in bonds, notes, certificates of indebtedness, or Treasury bills of the United States or in other such obligations fully guaranteed as to principal and interest by the United States;

(ii) extensions of credit to or secured by unconditional takeout commitments or guarantees of any department, agency, bureau, board, commission, or establishment of the United States or any corporation wholly owned directly or indirectly by the United States;

(iii) extensions of credit secured by a perfected security interest in a segregated deposit account in the lending bank; or

(iv) extensions of credit arising from the discount of negotiable installment consumer paper that is acquired from an insider and carries a full or partial recourse endorsement or guarantee by the insider,[9] provided that—

(A) the financial condition of each maker of such consumer paper is reasonably documented in the bank's files or known to its officers;

(B) an officer of the bank designated for that purpose by the board of directors of the bank certifies in writing that the bank is relying primarily upon the responsibility of each maker for the payment of the obligation and not upon any endorsement or guarantee by the insider; and

(C) the maker of the instrument is not an insider.

(e) *Overdrafts.* A member bank may not pay an overdraft of an executive officer or director

9. The exceptions to the aggregate lending limit pertaining to extensions of credit secured in the manner described above (i through iii) apply only to the amounts of such extensions of credit that are secured in such manner.

of the bank[10] on an account at the bank, unless the payment of funds is made in accordance with (1) a written, preauthorized, interest-bearing extension of credit plan that specifies a method of repayment or (2) a written, preauthorized transfer of funds from another account of the account holder at the bank.

The prohibition above does not apply to payment of inadvertent overdrafts on an account in an aggregate amount of $1,000 or less, provided (1) the account is not overdrawn for more than five business days and (2) the member bank charges the executive officer or director the same fee charged any other customer of the bank in similar circumstances.[11]

2050.0.3.4 Additional Restrictions on Loans to Executive Officers of Member Banks

The following restrictions on extensions of credit by a member bank to any of its executive officers are in addition to any restrictions on extensions of credit by a member bank to insiders of itself or its affiliates. The restrictions listed below apply only to the executive officers of the member bank and not to the executive officers of its affiliates.

A member bank may not extend credit to any of its executive officers, and no executive officer of a member bank can borrow from or otherwise become indebted to the bank, except in the amounts, for the purposes, and upon the conditions specified in items 3 and 4 below.

A member bank is authorized to extend credit to any executive officer of the bank—

(1) in any amount to finance the education of the executive officer's children;

(2) in any amount to finance or refinance the purchase, construction, maintenance, or improvement of a residence of the executive officer, provided—

(i) the extension of credit is secured by a first lien on the residence and the residence is owned (or expected to be owned after the extension of credit) by the executive officer; and

(ii) in the case of refinancing, that only the amount used to repay the original extension of credit, together with the closing costs of the refinancing, and any additional amount thereof used for any of the purposes enumerated in item 2 above, are included within this category of credit;

(3) in any amount, if the extension of credit is secured in a manner described in the first three exceptions to the general limit of the aggregate lending limit (see section 2050.0.3.3, paragraph d, subparagraphs i to iii); and

(4) for any other purpose (not specified in items 1 through 3 above), if the aggregate amount of loans to that executive officer does not exceed, at any one time, the higher of 2.5 percent of the bank's unimpaired capital and unimpaired surplus or $25,000, but in no event more than $100,000.

Any extension of credit by a member bank to any of its executive officers must be—

(1) promptly reported to the member bank's board of directors,

(2) in compliance with the general prohibitions of section 215.4 of Regulation O (manual section 2050.0.3.3),

(3) preceded by the submission of a current detailed financial statement of the executive officer, and

(4) made subject to the condition in writing that the extension of credit will, at the option of the member bank, become due and payable at any time that the officer is indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit that may be made available by a member bank to any of its executive officers.

No member bank may extend credit in an aggregate amount greater than the amount permitted for general-purpose loans to an executive officer (section 215.5(c)(4) of Regulation O) to a partnership in which one or more of the bank's executive officers are partners and, either individually or together, hold a majority interest. The total amount of credit extended by a member bank to such partnership is considered to be extended to each executive officer of the member bank who is a member of the partnership.

Prohibition on knowingly receiving unauthorized extensions of credit. Insiders are prohibited from knowingly receiving (or permitting their related interests to receive) any extensions of credit not authorized by section 22(h) of the Federal Reserve Act and by Regulation O.

10. This prohibition does not apply to the payment by a member bank of an overdraft of a principal shareholder of the member bank, unless the principal shareholder is also an executive officer or director. This prohibition also does not apply to the payment by a member bank of an overdraft of a related interest of an executive officer, director, or principal shareholder of the member bank.

11. The requirement that the member bank charge the executive officer or director the same fee charged any other customer of the bank in similar circumstances does not prohibit the member bank from charging a fee provided for in a benefit or compensation program that satisfies the requirements detailed in section 2050.0.3.3, item (a).

2050.0.3.5 Grandfathering Provisions

(a) *Under FDICIA.* FDICIA provided that the amendments to Regulation O would not affect extensions of credit entered into on or before the effective date of the regulation. Therefore, extensions of credit, including lines of credit, made on or before May 18, 1992, are not required to comply with either the individual-borrower limit made applicable to directors and their related interests, or with the aggregate limit on all loans to insiders. All extensions of credit, loan renewals, and loan rollovers made after May 18, 1992, must comply with all of the provisions of Regulation O. In other words, banks cannot make new loans or renew outstanding extensions of credit in amounts that, when aggregated with all other outstanding loans to insiders, would exceed either of the new limits.

(b) *Extensions of credit outstanding on March 10, 1979.* Any extension of credit that was outstanding on March 10, 1979, and that would have, if made on or after March 10, 1979, violated the individual lending limit, had to be reduced in amount by March 10, 1980, to be in compliance with the aggregate lending limit of Regulation O. Any renewal or extension of such a credit extension on or after March 10, 1979, must have been made only on terms that would have brought it into compliance with the aggregate lending limit by March 10, 1980. However, any extension of credit made before March 10, 1979, that bears a specific maturity date of March 10, 1980, or later, had to be repaid in accordance with the repayment schedule in existence on or before March 10, 1979.

2050.0.3.6 Reports by Executive Officers

Each executive officer of a member bank who becomes indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit in section 215.5(c) of Regulation O (manual section 2050.0.3.4) must make a written report to the board of directors of the officer's bank within 10 days of the date the indebtedness reaches such a level. The report must state the lender's name, the date and amount of each extension of credit, any security for it, and the purposes for which the proceeds have been or are to be used.

Report on credit secured by BHC stock. In addition to the report required above, each executive officer or director of a member bank the shares of which are not publicly traded must report annually to the bank's board of directors the outstanding amount of any credit that was extended to the executive officer or director that is secured by shares of the member bank. (See also Regulation Y section 225.4(f) for the identical restriction on executive officers and directors of a bank holding company with loans secured by shares of the bank holding company.)

2050.0.3.7 Report on Credit to Executive Officers

Each member bank must include with (but not as part of) each report of condition (and copy thereof) filed pursuant to 12 U.S.C. 1817(a)(3) a report of all extensions of credit made by the member bank to its executive officers since the date of the bank's previous report of condition.

2050.0.3.8 Disclosure of Credit from Member Banks to Executive Officers and Principal Shareholders

(a) *Definitions.* For the purposes of this section, the following definitions apply:

(1) "Principal shareholder of a member bank" means a person (individual or a company), other than an insured bank, or branch or representative office of a foreign bank as defined in 12 U.S.C. 3101(7)[12] that, directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has power to vote more than 10 percent of any class of voting securities of the member bank or company. The term includes an individual or company that controls a principal shareholder (for example, a person that controls a bank holding company). Shares of a bank (including a foreign bank), bank holding company, or other company owned or controlled by a member of an individual's immediate family are considered to be held or controlled by the individual for the purposes of determining principal shareholder status.[13]

12. A *foreign bank* means any company organized under the laws of a foreign country, a territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands that engages in the business of banking, or any subsidiary or affiliate, organized under such laws, of any such company. This includes foreign commercial banks, foreign merchant banks, and other foreign institutions that engage in banking activities usual in connection with the business of banking in the countries where such foreign institutions are organized or operating.

13. See footnote 3.

(2) "Related interest" means (i) any company controlled by a person; or (ii) any political or campaign committee the funds or services of which will benefit a person or that is controlled by a person. A related interest does not include a bank or a foreign bank (as defined in 12 U.S.C. 3101(7)).

(b) *Public disclosure.* Upon receipt of a written request from the public, a member bank shall make available the names of each of its executive officers (with the exception of any executive officer of a bank holding company of which the member bank is a subsidiary or of any other subsidiary of that bank holding company unless the executive officer is also an executive officer of the member bank) and each of its principal shareholders to whom, or to whose related interests, the member bank had outstanding at the end of the latest previous quarter of the year, an extension of credit that, when aggregated with all other outstanding extensions of credit at that time from the member bank to such person and to all related interests of such person, equaled or exceeded 5 percent of the member bank's capital and unimpaired surplus or $500,000, whichever amount is less. No disclosure under this paragraph is required if the aggregate amount of all extensions of credit outstanding at that time from the member bank to the executive officer or principal shareholder of the member bank and to all related interests of such a person does not exceed $25,000.

A member bank is not required to disclose the specific amounts of individual extensions of credit.

(c) *Maintaining records.* Each member bank is required to maintain records of all requests for the information described above and the disposition of the requests. These records may be disposed of two years after the date of the request.

2050.0.3.9 Civil Penalties of Regulation O

Any member bank, or any officer, director, employee, agent, or other person participating in the conduct of the affairs of the bank, that violates any provision of Regulation O is subject to a civil penalty, as specified in section 29 of the Federal Reserve Act.

2050.0.3.10 Records of Member Banks (and BHCs)

To help inspection and examination personnel identify BHC officials, Regulation O requires each member bank to maintain records necessary to monitor compliance with this regulation. BHCs and nonbank subsidiaries should be given access to the records identifying "bank officials." Each state member bank is required to (1) identify, through an annual survey, all insiders of the bank itself; and (2) maintain records of all extensions of credit to insiders of the bank itself, including the amount and terms of each such extension of credit.

2050.0.3.10.1 Recordkeeping for Insiders of the Member Bank's Affiliates

A member bank is required to maintain records of extensions of credit to insiders of the member bank's affiliates by—

(1) a "survey" method, which identifies, through an annual survey, each of the insiders of the member bank's affiliates. Under the survey method, the member bank must maintain records of the amount and terms of each extension of credit by the member bank to such insiders or

(2) a "borrower inquiry" method, which requires, as part of each extension of credit, the borrower to indicate whether the borrower is an insider of an affiliate of the member bank. Under this method, the member bank must maintain records that identify the amount and terms of each extension of credit by the member bank to borrowers so identifying themselves.

Alternative recordkeeping method for insiders of affiliates. A member bank may use a recordkeeping method other than those identified above if the appropriate federal banking agency determines that the bank's method is at least as effective.

2050.0.3.10.2 Special Rule for Noncommercial Lenders

A member bank that is prohibited by law or by an express resolution of the bank's board of directors from making an extension of credit to any company, or other entity that is covered by Regulation O as a company, is not required to maintain any records of the related interests of the insiders of the bank or its affiliates. The bank is also not required to inquire of borrowers whether they are related interests of the insiders of the bank or its affiliates.

2050.0.3.11 Section 23A Ramifications

Loans to a holding company parent and its affiliates are governed by section 23A of the Federal Reserve Act and are not subject to Regulation O.

2050.0.4 REMEDIAL ACTION

Self-serving and abusive transactions deprive a BHC of opportunities and benefits that may otherwise have been available and may strip a BHC of its ability to serve as a source of financial and managerial strength to its subsidiary banks. Even if not extended on preferential terms, self-serving loans and other extensions of credit to insiders may be an imprudent business practice and may reduce the lender's liquidity or otherwise overextend the BHC. In such situations, formal or informal remedial measures by the Federal Reserve may be necessary. Formal enforcement action is provided for in the 1974 amendments to the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818), which grant the Board authority to issue cease-and-desist orders in appropriate situations. For complete details on formal corrective actions, see section 2110.0.

2050.0.5 INSPECTION OBJECTIVES

1. To determine if any transactions between BHC officials, their related interests, and the BHC or its nonbank subsidiaries are based on preferential treatment.
2. To determine if any transactions between BHC officials, their related interests, and the BHC or its nonbank subsidiaries result in any undue loss exposure to the BHC or its subsidiaries.
3. To determine if any BHC or nonbank extension of credit to a BHC official or related interest is in the spirit of Regulation O's requirements or whether it is an attempt to circumvent Regulation O's prohibition on various bank extensions of credit to similar parties.
4. To determine that BHC officials are aware of Regulation O's limitations and prohibitions and have established internal policies and procedures for the bank subsidiaries to ensure compliance by the banks.
5. To determine that the BHC has arranged to make available, upon request, a listing or some other form of information sufficient to identify all "BHC officials" and to make certain that such information is available to the bank subsidiaries in particular.

2050.0.6 INSPECTION PROCEDURES

1. Review the balance sheets and other records of the parent-only and nonbank subsidiaries to determine if there are any loans or other extensions of credit to BHC officials.
2. Review the income statements and supporting records of the parent-only and nonbank subsidiaries to determine if any interest income, other income, or expense is associated with a transaction with a BHC official or a related interest.
3. Ask management to identify all such transactions and to provide supporting documentation.
4. Review management's familiarity with Regulation O's limitations and the steps they have taken to establish policies for the internal administration of their subsidiary banks' extensions of credit to BHC officials.
5. Review any information prepared by management that presents a listing of all BHC officials and their related interests.
6. Review any corporate resolutions declaring an individual not to be an "executive officer" for purposes of Regulation O and, if necessary, confirm the individual's nonparticipation in the formulation of corporate policy.
7. As the provision of Regulation O apply to the BHC and its subsidiaries, determine if the BHC provides employees or other insiders with extensions of credit, including BHC-owned or BHC-issued credit cards. Find out if any of the credit cards are used to conduct the BHC's business.
   a. Verify that the BHC has a written policy that forbids or discourages an employee or other insider from using a BHC-owned or BHC-issued credit card for the insider's personal purposes and that the policy obligates the insider to promptly make reimbursement to the BHC.
   b. Determine the BHC's compliance with Regulation O regarding its extensions of credit (including BHC-owned or BHC-issued credit card loans) to insiders.

Verify that the BHC monitors the amount of personal charges outstanding on its BHC-owned or BHC-issued credit cards that are held by insiders so that the outstanding charges, when aggregated with all of an insider's other indebtedness owed to the BHC, do not exceed $15,000.

c. Verify the BHC's compliance with the market-terms requirement of Regulation O. Determine if—
   - the BHC requires employees and other insiders who have extensions of credit, or use BHC-owned or BHC-issued credit cards for personal purposes, to meet the BHC's normal credit underwriting standards and
   - the BHC has verified that the insiders' extensions of credit (or BHC-owned or BHC-issued credit cards) do not have more preferential terms (for example, a lower interest rate or a longer repayment period) than the consumer credit cards offered by the BHC.

2050.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans and extensions of credit to executive officers, directors, and principal shareholders	375a and 375b (sections 22(g) and 22(h) of F.R. Act)	215.4 215.5 (Reg. O)		
Granting of below-market interest rate mortgage loans to executives of BHC subsidiaries as compensation	1972(2)		4–514 3–1094	
Restrictions on loans to insiders of a bank or its correspondent bank	1972 (2)			
Board staff interpretation on the use of bank-owned or bank-issued credit cards by bank insiders			3–1081.5	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Management Information Systems refers to the policies and operating procedures, including systems of internal control, that the board of directors of a bank holding company initiates to monitor and ensure control of its operations and activities, while maintaining and improving the financial strength and objectives of the overall organization. These policies should focus on the overall organizational structure with respect to identifying, monitoring, and managing risks. Subsequent sections of the manual focus on the essential elements of various management information systems. Included are inspection objectives and procedures to be used by Federal Reserve Bank examiners when conducting inspections of bank holding companies.

See 2060.05 Internal Audit Function and Its Outsourcing
2060.1 Audit
2060.2 Budget
2060.3 Records and Statements
2060.4 Reporting
2060.5 Insurance
5052.0 Targeted MIS Inspection

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2014, this section was revised to include new and revised inspection objectives and inspection procedures for both the 2003 interagency guidance, "Policy Statement on the Internal Audit Function and its Outsourcing," and the January 23, 2013, Federal Reserve "Supplemental Policy Statement on Internal Audit Function and its Outsourcing." Refer to SR-03-5 and SR 13-1/CA 13-1 and Manual section 2060.07.

2060.05.01 AN EFFECTIVE SYSTEM OF INTERNAL CONTROLS

Effective internal control[1] is a foundation for the safe and sound operation of a financial institution (institution).[2] The board of directors and senior management of an institution are responsible for ensuring that the system of internal control operates effectively. Their responsibility cannot be delegated to others within the institution or to outside parties. An important element in assessing the effectiveness of the internal control system is an internal audit function. When properly structured and conducted, internal audit provides directors and senior management with vital information about weaknesses in the system of internal control so that management can take prompt, remedial action. The federal banking agencies'[3] (agencies) longstanding inspection policies call for examiners to review an institution's internal audit function and recommend improvements, if needed. In addition, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1831p-1), the agencies have adopted Interagency Guidelines Establishing Standards for Safety and Soundness that apply to insured depository institutions.[4] Under these guidelines and policies, each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In addressing various quality and resource issues, many institutions have been engaging independent public accounting firms and other outside professionals (outsourcing vendors) in recent years to perform work that traditionally has been done by internal auditors. These arrangements are often called "internal audit outsourcing," "internal audit assistance," "audit co-sourcing," and "extended audit services" (hereafter, collectively referred to as outsourcing). Typical outsourcing arrangements are more fully illustrated in part II below.

Outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. However, the agencies have concerns that the structure, scope, and management of some internal audit outsourcing arrangements do not contribute to the institution's safety and soundness. Furthermore, the agencies want to ensure that these arrangements with outsourcing vendors do not leave directors and senior management with the erroneous impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.

The Sarbanes-Oxley Act of 2002 (the act) became law on July 30, 2002.[5] The act addresses weaknesses in corporate governance and the

1. In summary, internal control is a process designed to provide reasonable assurance that the institution will achieve the following internal control objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components, which is brought about by an institution's board of directors, management, and other personnel, is essential to achieving the internal control objectives. This description of internal control is consistent with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report *Internal Control—Integrated Framework*. In addition, under the COSO framework, financial reporting is defined in terms of published financial statements, which, for purposes of this policy statement, encompass both financial statements prepared in accordance with generally accepted accounting principles and regulatory reports (such as the Reports of Condition and Income). Institutions are encouraged to evaluate their internal control against the COSO framework.

2. The term "institution" includes depository institutions insured by the Federal Deposit Insurance Corporation (FDIC), U.S. financial holding companies and bank holding companies supervised by the Federal Reserve System, thrift holding companies supervised by the Office of Thrift Supervision (OTS), and the U.S. operations of foreign banking organizations.

3. The Board of Governors of the Federal Reserve System (FRS), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS).

4. For national banks, appendix A to part 30; for state member banks, appendix D-1 to part 208; for insured state nonmember banks and insured state-licensed branches of foreign banks, appendix A to part 364; for savings associations, appendix A to part 570.

5. Pub. L. No. 107-204.

accounting and auditing professions, and includes provisions addressing audits, financial reporting and disclosure, conflicts of interest, and corporate governance at publicly owned companies. The act, among other things, requires public companies to have an audit committee composed entirely of independent directors. Public banking organizations that are listed on the New York Stock Exchange (NYSE) and Nasdaq must also comply with those exchanges' listing requirements, which include audit committee requirements.

The act also established a Public Company Accounting Oversight Board (PCAOB) that has the authority to set and enforce auditing, attestation, quality control, and ethics (including independence) standards for auditors of public companies, subject to SEC review. (See SR-02-20.) Accounting firms that conduct audits of public companies (i.e., registered accounting firms) must register with the PCAOB and be subject to its supervision. The PCAOB is also empowered to inspect the auditing operations of public accounting firms that audit public companies, as well as impose disciplinary and remedial sanctions for violations of its rules, securities laws, and professional auditing and accounting standards.

[Sections 2060.05.02–2060.05.04 are reserved.]

2060.05.05 APPLICATION OF THE SARBANES-OXLEY ACT TO NONPUBLIC BANKING ORGANIZATIONS

In May 2003, the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision announced that they did not expect to take actions to apply the corporate-governance and other requirements of the Sarbanes-Oxley Act generally to nonpublic banking organizations that are not otherwise subject to them.[5a] (See SR-03-08.) The agencies, however, encouraged nonpublic banking organizations to periodically review their policies and procedures relating to corporate-governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the organization's size, operations, and resources. Furthermore, the agencies stated that a banking organization's policies and procedures for corporate governance, internal controls, and auditing will be assessed during the supervisory process, and the agencies may take appropriate supervisory action if there are deficiencies or weaknesses in these areas that are inconsistent with sound corporate-governance practices or safety-and-soundness considerations.

2060.05.06 INTERAGENCY POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

The Federal Reserve and other federal banking agencies[6] adopted on March 17, 2003, an interagency policy statement addressing the internal audit function and its outsourcing (See SR 03-5). The policy statement revises and replaces the former 1997 policy statement and incorporates recent developments in internal auditing. In addition, the revised policy incorporates guidance on the independence of accountants who provide institutions with both internal and external audit services in light of the Sarbanes-Oxley Act of 2002 and associated SEC rules. (See also sections 2124.0.2.4, 2060.1, 3230.0.10.2.5, 5010.7, and 5030.0 [page 7] pertaining to internal and external audits.)

The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit services to the company. The policy statement discusses the applicability of this prohibition to institutions that are public companies, insured depository institutions with assets of $500 million or more that are subject to the annual audit and reporting requirements of section 36 of the Federal Deposit Insurance Act, and also nonpublic institutions that are not subject to section 36.

5a. As discussed below, some aspects of the auditor-independence rules established by the Sarbanes-Oxley Act apply to all federally insured depository institutions with $500 million or more in total assets. See part 363 of the FDIC's regulations.

6. The FDIC, OCC, and OTS.

2060.05.1 INTERNAL AUDIT FUNCTION (PART I)

2060.05.1.1 Director and Senior Management Responsibilities for Internal Audit

The board of directors and senior management are responsible for having an effective system of internal control and an effective internal audit function in place at their institution. They are also responsible for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility cannot be delegated to anyone else. They may, however, delegate the design, implementation, and monitoring of specific internal controls to lower-level management and the testing and assessment of internal controls to others. Accordingly, directors and senior management should have reasonable assurance that the system of internal control prevents or detects significant inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting (which includes regulatory reporting); and deviations from laws, regulations, and the institution's policies.[7]

Some institutions have chosen to rely on so-called management self-assessments or control self-assessments, wherein business-line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and members of senior management who rely too much on these reviews may not learn of control weaknesses until they have become costly problems, particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and evaluated by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function addresses the risks and meets the demands posed by the institution's current and planned activities. To accomplish this objective, directors should consider whether their institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing*. These standards address independence, professional proficiency, scope of work, performance of audit work, management of internal audit, and quality-assurance reviews. Furthermore, directors and senior management should ensure that the following matters are reflected in their institution's internal audit function.

2060.05.1.1.1 Internal Audit Placement and Structure Within the Organization

Careful thought should be given to the placement of the audit function in the institution's management structure. The internal audit function should be positioned so that the board has confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. The audit committee,[8] using objective criteria it has established, should oversee the internal audit function and evaluate its per-

7. As noted above, under section 36 of the FDI Act, as implemented by part 363 of the FDIC's regulations (12 C.F.R. 363), FDIC-insured depository institutions with total assets of $500 million or more must submit an annual management report signed by the chief executive officer (CEO) and chief accounting or chief financial officer. This report must contain the following: (1) a statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness, including management's assessment of the institution's compliance with those laws and regulations; and (2) for an institution with total assets of $1 billion or more at the beginning of the institution's most recent fiscal year, the report should include an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year. (See 12 C.F.R. 363.2(b) and 70 *Fed. Reg. 71,232, November 28, 2005.)*

8. Depository institutions subject to section 36 of the FDI Act and part 363 of the FDIC's regulations must maintain an independent audit committee (i.e., consisting of directors who are *not* members of management). For institutions with between $500 million and $1 billion in assets, only a majority, rather than all, of the members of the audit committee—who must be outside directors—must be independent of management. For insured institutions having total assets of more than $3 billion, the audit committee must (1) have members with banking or related financial management expertise, (2) have access to outside legal counsel, and (3) not include any large customers of the institution. The audit committee also may be required to satisfy other audit committee membership criteria (see 12 U.S.C. 831m(g)(1)(c) and section 363.5(b)(12 C.F.R. 363.5(b)). Consistent with the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, the agencies also encourage the board of directors of each depository institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. Where the term ''audit committee'' is used in this policy statement, the board of directors may fulfill the audit committee responsibilities if the institution is not subject to an audit committee requirement.

formance.[9] The audit committee should assign responsibility for the internal audit function to a member of management (that is, the manager of internal audit or internal audit manager) who understands the function and has no responsibility for operating the system of internal control. The ideal organizational arrangement is for this manager to report directly and solely to the audit committee regarding both audit issues and administrative matters (e.g., resources, budget, appraisals, and compensation). Institutions are encouraged to consider the IIA's *Practice Advisory 2060-2: Relationship with the Audit Committee*, which provides more guidance on the roles and relationships between the audit committee and the internal audit manager.

Many institutions place the manager of internal audit under a dual reporting arrangement: functionally accountable to the audit committee on issues discovered by the internal audit function, while reporting to another senior manager on administrative matters. Under a dual reporting relationship, the board should consider the potential for diminished objectivity on the part of the internal audit manager with respect to audits concerning the executive to whom he or she reports. For example, a manager of internal audit who reports to the chief financial officer (CFO) for performance appraisal, salary, and approval of department budgets may approach audits of the accounting and treasury operations controlled by the CFO with less objectivity than if the manager were to report to the chief executive officer. Thus, the chief financial officer, controller, or other similar officer should ideally be excluded from overseeing the internal audit activities even in a dual role. The objectivity and organizational stature of the internal audit function are best served under such a dual arrangement if the internal audit manager reports administratively to the CEO.

Some institutions seek to coordinate the internal audit function with several risk-monitoring functions (for example, loan review, market-risk assessment, and legal compliance departments) by establishing an administrative arrangement under one senior executive. Coordination of these other monitoring activities with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better use available resources, and enhance the institution's ability to comprehensively manage risk. Such an administrative reporting relationship should be designed so as to not interfere with or hinder the manager of internal audit's functional reporting to and ability to directly communicate with the institution's audit committee. In addition, the audit committee should ensure that efforts to coordinate these monitoring functions do not result in the manager of internal audit conducting control activities nor diminish his or her independence with respect to the other risk-monitoring functions. Furthermore, the internal audit manager should have the ability to independently audit these other monitoring functions.

In structuring the reporting hierarchy, the board should weigh the risk of diminished independence against the benefit of reduced administrative burden in adopting a dual reporting organizational structure. The audit committee should document its consideration of this risk and mitigating controls. The IIA's *Practice Advisory 1110-2: Chief Audit Executive Reporting Lines* provides additional guidance regarding functional and administrative reporting lines.

2060.05.1.1.2 Internal Audit Management, Staffing, and Audit Quality

In managing the internal audit function, the manager of internal audit is responsible for control risk assessments, audit plans, audit programs, and audit reports.

1. A control risk assessment (or risk-assessment methodology) documents the internal auditor's understanding of the institution's significant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line, the mitigating control processes, and the resulting residual risk exposure of the institution. They should be updated regularly to reflect changes to the system of internal control or work processes and to incorporate new lines of business.
2. An internal audit plan is based on the control risk assessment and typically includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
3. An internal audit program describes the objectives of the audit work and lists the

9. For example, the performance criteria could include the timeliness of each completed audit, comparison of overall performance to plan, and other measures.

procedures that will be performed during each internal audit review.

4. An audit report generally presents the purpose, scope, and results of the audit, including findings, conclusions, and recommendations. Workpapers that document the work performed and support the audit report should be maintained.

Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk-management, control, and governance processes. Internal auditors increasingly have taken a consulting role within institutions on new products and services and on mergers, acquisitions, and other corporate reorganizations. This role typically includes helping design controls and participating in the implementation of changes to the institution's control activities. The audit committee, in its oversight of the internal audit staff, should ensure that the function's consulting activities do not interfere or conflict with the objectivity it should have with respect to monitoring the institution's system of internal control. In order to maintain its independence, the internal audit function should not assume a business-line management role over control activities, such as approving or implementing operating policies or procedures, including those it has helped design in connection with its consulting activities. The agencies encourage internal auditors to follow the IIA's standards, including guidance related to the internal audit function acting in an advisory capacity.

The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and assess whether internal controls are effective. The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff. The form and content of these policies and procedures should be consistent with the size and complexity of the department and the institution. Many policies and procedures may be communicated informally in small internal audit departments, while larger departments would normally require more formal and comprehensive written guidance.

2060.05.1.1.3 Internal Audit Frequency and Scope

The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve internal audit's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vendor. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.[10]

2060.05.1.1.4 Communication of Internal Audit Findings to the Directors, Audit Committee, and Management

To properly carry out their responsibility for internal control, directors and senior management should foster forthright communications and critical inspection of issues to better understand the importance and severity of internal control weaknesses identified by the internal auditor and operating management's solutions to these weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether management is expeditiously resolving internal control weaknesses and other exceptions. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without management being present.

10. Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These include (1) new management; (2) areas or activities experiencing rapid growth or rapid decline; (3) new lines of business, products, or technologies or disposals thereof; (4) corporate restructurings, mergers, and acquisitions; and (5) expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

Furthermore, each audit committee should establish and maintain procedures for employees of their institution to submit confidentially and anonymously concerns to the committee about questionable accounting, internal accounting control, or auditing matters.[11] In addition, the audit committee should set up procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution.

2060.05.1.1.5 Contingency Planning

As with any other function, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas. Lack of contingency planning for continuing internal audit coverage may increase the institution's level of operational risk.

2060.05.1.2 U.S. Operations of Foreign Banking Organizations

The internal audit function of a foreign banking organization (FBO) should cover its U.S. operations in its risk assessments, audit plans, and audit programs. Its U.S.-domiciled audit function, head-office internal audit staff, or some combination thereof normally performs the internal audit of the U.S. operations. Internal audit findings (including internal control deficiencies) should be reported to the senior management of the U.S. operations of the FBO and the audit department of the head office. Significant adverse findings also should be reported to the head office's senior management and the board of directors or its audit committee.

2060.05.1.3 Internal Audit Systems and the Audit Function for Small Financial Institutions

An effective system of internal control and an independent internal audit function form the foundation for safe and sound operations, regardless of an institution's size. Each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing and review of internal controls and information systems.

It is the responsibility of the audit committee and management to carefully consider the extent of auditing that will effectively monitor the internal control system after taking into account the internal audit function's costs and benefits. For institutions that are large or have complex operations, the benefits derived from a full-time manager of internal audit or an auditing staff likely outweigh the cost. For small institutions with few employees and less complex operations, however, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a comprehensive set of independent reviews of significant internal controls. The key characteristic of such reviews is that the person(s) directing and/or performing the review of internal controls is not also responsible for managing or operating those controls. A person who is competent in evaluating a system of internal control should design the review procedures and arrange for their implementation. The person responsible for reviewing the system of internal control should report findings directly to the audit committee. The audit committee should evaluate the findings and ensure that senior management has or will take appropriate action to correct the control deficiencies.

2060.05.2 INTERNAL AUDIT OUTSOURCING ARRANGEMENTS (PART II)

2060.05.2.1 Examples of Internal Audit Outsourcing Arrangements

An outsourcing arrangement is a contract between an institution and an outsourcing vendor to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. Some institutions consider entering into these arrangements to enhance the quality of their control environment by obtaining the services of a vendor with the knowledge and skills to critically assess, and recommend improvements to, their internal control systems. The internal audit services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal

11. Where the board of directors fulfills the audit committee responsibilities, the procedures should provide for the submission of employee concerns to an outside director.

audit, and the outsourcing vendor reports to him or her. Institutions often use outsourcing vendors for audits of areas requiring more technical expertise, such as electronic data processing and capital-markets activities. Such uses are often referred to as ''internal audit assistance'' or ''audit co-sourcing.''

Some outsourcing arrangements may require an outsourcing vendor to perform virtually all the procedures or tests of the system of internal control. Under such an arrangement, a designated manager of internal audit oversees the activities of the outsourcing vendor and typically is supported by internal audit staff. The outsourcing vendor may assist the audit staff in determining risks to be reviewed and may recommend testing procedures, but the internal audit manager is responsible for approving the audit scope, plan, and procedures to be performed. Furthermore, the internal audit manager is responsible for the results of the outsourced audit work, including findings, conclusions, and recommendations. The outsourcing vendor may report these results jointly with the internal audit manager to the audit committee.

2060.05.2.2 Additional Inspection and Examination Considerations for Internal Audit Outsourcing Arrangements

Even when outsourcing vendors provide internal audit services, the board of directors and senior management of an institution are responsible for ensuring that both the system of internal control and the internal audit function operate effectively. In any outsourced internal audit arrangement, the institution's board of directors and senior management must maintain ownership of the internal audit function and provide active oversight of outsourced activities. When negotiating the outsourcing arrangement with an outsourcing vendor, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control will go undetected.

To clearly distinguish its duties from those of the outsourcing vendor, the institution should have a written contract, often taking the form of an engagement letter.[12] Contracts between the institution and the vendor typically include provisions that—

1. define the expectations and responsibilities under the contract for both parties;
2. set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
3. set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
4. establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and stipulations for default and termination of the contract;
5. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor;
6. specify the locations of internal audit reports and the related workpapers;
7. specify the period of time (for example, seven years) that vendors must maintain the workpapers;[13]
8. state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor;
9. prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence; and
10. state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if

12. The engagement letter provisions described are comparable to those outlined by the American Institute of Certified Public Accountants (AICPA) for financial statement audits (see AICPA Professional Standards, AU section 310). These provisions are consistent with the provisions customarily included in contracts for other outsourcing arrangements, such as those involving data processing and information technology. Therefore, the federal banking agencies consider these provisions to be usual and customary business practices.

13. If the workpapers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the bank and examiners to access the electronic workpapers for a specified time period.

applicable, will comply with AICPA, SEC, PCAOB, or regulatory independence guidance.

2060.05.2.2.1 Management of the Outsourced Internal Audit Function

Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vendor. Small institutions that do not employ a full-time audit manager should appoint a competent employee who ideally has no managerial responsibility for the areas being audited to oversee the outsourcing vendor's performance under the contract. This person should report directly to the audit committee for purposes of communicating internal audit issues.

2060.05.2.2.2 Communication of Outsourced Internal Audit Findings to Directors and Senior Management

Communication between the internal audit function and the audit committee and senior management should not diminish because the institution engages an outsourcing vendor. All work by the outsourcing vendor should be well documented and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vendor's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vendor. In deciding what issues should be brought to the board's attention, the concept of "materiality," as the term is used in financial statement audits, is generally not a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

2060.05.2.2.3 Competence of Outsourced Internal Audit Vendor

Before entering an outsourcing arrangement, the institution should perform due diligence to satisfy itself that the outsourcing vendor has sufficient staff qualified to perform the contracted work. The staff's qualifications may be demonstrated, for example, through prior experience with financial institutions. Because the outsourcing arrangement is a personal-services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vendor and receive timely notice of key staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vendor maintains sufficient expertise to effectively perform its contractual obligations.

2060.05.2.2.4 Contingency Planning to Avoid Discontinuity of Internal Audit Coverage

When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it may increase its operational risk. Because the arrangement may be terminated suddenly, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas.

2060.05.3 INDEPENDENCE OF THE INDEPENDENT PUBLIC ACCOUNTANT (PART III)

The following discussion applies only when a financial institution is considering using a public accountant to provide both external audit and internal audit services to the institution.

When one accounting firm performs both the external audit and the outsourced internal audit function, the firm risks compromising its independence. These concerns arise because, rather than having two separate functions, this outsourcing arrangement places the independent public accounting firm in the position of appearing to audit, or actually auditing, its own work. For example, in auditing an institution's financial statements, the accounting firm will consider the extent to which it may rely on the internal control system, including the internal audit function, in designing audit procedures.

2060.05.3.1 Applicability of the SEC's Auditor Independence Requirements

2060.05.3.1.1 Institutions That Are Public Companies

To strengthen auditor independence, Congress passed the Sarbanes-Oxley Act of 2002 (the act). Title II of the act applies to any public company—that is, any company that has a class of securities registered with the SEC or the appropriate federal banking agency under section 12 of the Securities Exchange Act of 1934 or that is required to file reports with the SEC under section 15(d) of that act.[14] The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit outsourcing services to the company.[15] In addition, if a public company's external auditor will be providing auditing services and permissible nonaudit services, such as tax services, the company's audit committee must preapprove each of these services.

According to the SEC's final rules (effective May 6, 2003) implementing the act's nonaudit service prohibitions and audit committee preapproval requirements, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides internal audit outsourcing or other prohibited nonaudit services to the public company audit client. The SEC's final rules generally become effective May 6, 2003, although a one-year transition period is provided if the accountant is performing prohibited nonaudit services and actual audit services for a public company pursuant to a contract in existence on May 6, 2003. The services provided during this transition period, however, must not have impaired the auditor's independence under the preexisting independence requirements of the SEC, the Independence Standards Board, and the AICPA. Although the SEC's pre-Sarbanes-Oxley independence requirements (issued November 2000 (effective August 2002)) did not prohibit the outsourcing of internal audit services to a public company's independent public accountant, they did place conditions and limitations on internal audit outsourcing.

2060.05.3.1.2 Depository Institutions Subject to the Annual Audit and Reporting Requirements of Section 36 of the FDI Act

Under section 36, as implemented by part 363 of the FDIC's regulations, each FDIC-insured depository institution with total assets of $500 million or more is required to have an annual audit performed by an independent public accountant.[16] The part 363 guidelines address the qualifications of an independent public accountant engaged by such an institution by stating that "[t]he independent public accountant should also be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff."[17]

Thus, the guidelines provide for each FDIC-insured depository institution with $500 million or more in total assets, whether or not it is a public company, and its external auditor to comply with the SEC's auditor independence requirements that are in effect during the period covered by the audit. These requirements include the nonaudit-service prohibitions and audit committee preapproval requirements implemented by the SEC's January 2003 auditor independence rules, once the rules come into effect.[18]

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14. 15 U.S.C. 78*l* and 78o(d).

15. In addition to prohibiting internal audit outsourcing, the Sarbanes-Oxley Act (15 U.S.C. 78j-1) also identifies other nonaudit services that an external auditor is prohibited from providing to a public company whose financial statements it audits. The legislative history of the act indicates that three broad principles should be considered when determining whether an auditor should be prohibited from providing a nonaudit service to an audit client. These principles are that an auditor should not (1) audit his or her own work, (2) perform management functions for the client, or (3) serve in an advocacy role for the client. To do so would impair the auditor's independence. Based on these three broad principles, the other nonaudit services . . . referred to in this section . . . that an auditor is prohibited from providing to a public company audit client include bookkeeping or other services related to the client's accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; legal services and expert services unrelated to the audit; and any other service determined to be impermissible by the PCAOB.

16. 12 C.F.R. 363.3(a). (See FDIC Financial Institutions Letter, FIL-17-2003 (Corporate Governance, Audits, and Reporting Requirements), Attachment II, March 5, 2003.)

17. Appendix A to part 363, Guidelines and Interpretations, paragraph 14, Independence.

18. If a depository institution subject to section 36 and part 363 satisfies the annual independent audit requirement by relying on the independent audit of its parent holding company, once the SEC's January 2003 regulations prohibiting an external auditor from performing internal audit outsourcing services for an audit client take effect May 6, 2003, or May 6, 2004, depending on the circumstances, the holding company's external auditor cannot perform internal audit outsourcing

2060.05.3.1.3 Institutions Not Subject to Section 36 of the FDI Act That Are Neither Public Companies Nor Subsidiaries of Public Companies

The agencies have long encouraged each institution not subject to section 36 of the FDI Act that is neither a public company nor a subsidiary of a public company[19] to have its financial statements audited by an independent public accountant.[20] The agencies also encourage each such institution to follow the internal audit outsourcing prohibition in the Sarbanes-Oxley Act, as discussed above for institutions that are public companies. As previously mentioned, some institutions seek to enhance the quality of their control environment by obtaining the services of an outsourcing vendor who can critically assess their internal control system and recommend improvements. The agencies believe that a small nonpublic institution with less complex operations and limited staff can, in certain circumstances, use the same accounting firm to perform both an external audit and some or all of the institution's internal audit activities. These circumstances include, but are not limited to, situations where—

1. splitting the audit activities poses significant costs or burden,
2. persons with the appropriate specialized knowledge and skills are difficult to locate and obtain,
3. the institution is closely held and investors are not solely reliant on the audited financial statements to understand the financial position and performance of the institution, and
4. the outsourced internal audit services are limited in either scope or frequency.

In circumstances such as these, the agencies view an internal audit outsourcing arrangement between a small nonpublic institution and its external auditor as not being inconsistent with their safety-and-soundness objectives for the institution.

When a small nonpublic institution decides to hire the same firm to perform internal and external audit work, the audit committee and the external auditor should pay particular attention to preserving the independence of both the internal and external audit functions. Furthermore, the audit committee should document both that it has preapproved the internal audit outsourcing to its external auditor and has considered the independence issues associated with this arrangement.[21] In this regard, the audit committee should consider the independence standards described in parts I and II of the policy statement, the AICPA guidance discussed below, and the broad principles that the auditor should not perform management functions or serve in an advocacy role for the client.

Accordingly, the agencies will not consider an auditor who performs internal audit outsourcing services for a small nonpublic audit client to be independent unless the institution and its auditor have adequately addressed the associated independence issues. In addition, the institution's board of directors and management must retain ownership of and accountability for the internal audit function and provide active oversight of the outsourced internal audit relationship.

A small nonpublic institution may be required by another law or regulation, an order, or another supervisory action to have its financial statements audited by an independent public accountant. In this situation, if warranted for safety-and-soundness reasons, the institution's primary federal regulator may require that the institution and its independent public accountant comply with the auditor independence requirements of the Act.[22]

2060.05.3.1.4 AICPA Guidance

As noted above, the independent public accountant for a depository institution subject to section 36 of the FDI Act also should be in compliance with the AICPA's *Code of Professional Conduct*. This code includes professional ethics standards, rules, and interpretations that are binding on all certified public accountants (CPAs) who are members of the AICPA in order

work for that holding company or the subsidiary institution.

19. FDIC-insured depository institutions with less than $500 million in total assets are not subject to section 36 of the FDI Act. Section 36 does not apply directly to holding companies, but it provides that, for an insured depository institution that is a subsidiary of a holding company, its audited financial statements requirement and certain of its other requirements may be satisfied by the holding company.

20. See, for example, the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions.

21. If a small nonpublic institution is considering having its external auditor perform other nonaudit services, its audit committee may wish to discuss the implications of the performance of these services on the auditor's independence.

22. 15 U.S.C. 78j-1.

for the member to remain in good standing. Therefore, this code applies to each member CPA who provides audit services to an institution, regardless of whether the institution is subject to section 36 or is a public company.

The AICPA has issued guidance indicating that a member CPA would be deemed not independent of his or her client when the CPA acts or appears to act in a capacity equivalent to a member of the client's management or as a client employee. The AICPA's guidance includes illustrations of activities that would be considered to compromise a CPA's independence. Among these are activities that involve the CPA authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client. For additional details, refer to Interpretation 101-3, Performance of Other Services, and Interpretation 101-13, Extended Audit Services, in the AICPA's *Code of Professional Conduct*.

2060.05.4 INSPECTION GUIDANCE (PART IV)

2060.05.4.1 Review of the Internal Audit Function and Outsourcing Arrangements

Examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their inspection work and may subject the institution to follow-up supervisory actions.

Examiners should assess the quality and scope of an institution's internal audit function, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Specifically, examiners should consider whether—

1. the internal audit function's control risk assessment, audit plans, and audit programs are appropriate for the institution's activities;
2. the internal audit activities have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
3. the internal audit activities are consistent with the long-range goals and strategic direction of the institution and are responsive to its internal control needs;
4. the audit committee promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;
5. the internal audit manager is placed in the management structure in such a way that the independence of the function is not impaired;
6. the institution has promptly responded to significant identified internal control weaknesses;
7. the internal audit function is adequately managed to ensure that audit plans are met, programs are carried out, and results of audits are promptly communicated to senior management and members of the audit committee and board of directors;
8. workpapers adequately document the internal audit work performed and support the audit reports;
9. management and the board of directors use reasonable standards, such as the IIA's *Standards for the Professional Practice of Internal Auditing*, when assessing the performance of internal audit; and
10. the audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

The examiner should assess the competence of the institution's internal audit staff and management by considering the education, professional background, and experience of the principal internal auditors. In addition, when reviewing outsourcing arrangements, examiners should determine whether—

1. the arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
2. key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
3. the scope of the outsourced work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
4. the directors have ensured that the outsourced internal audit activities are effectively managed by the institution;
5. the arrangement with the outsourcing vendor satisfies the independence standards described in this policy statement and

thereby preserves the independence of the internal audit function, whether or not the vendor is also the institution's independent public accountant; and
6. the institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.

2060.05.4.2 Inspection Concerns About the Adequacy of the Internal Audit Function

If the examiner concludes that the institution's internal audit function, whether or not it is outsourced, does not sufficiently meet the institution's internal audit needs; does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, if applicable; or is otherwise inadequate, he or she should determine whether the scope of the inspection should be adjusted. The examiner should also discuss his or her concerns with the internal audit manager or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's concerns, he or she should bring these matters to the attention of senior management and the board of directors or audit committee. Should the examiner find material weaknesses in the internal audit function or the internal control system, he or she should discuss them with appropriate agency staff in order to determine the appropriate actions the agency should take to ensure that the institution corrects the deficiencies. These actions may include formal and informal enforcement actions.

The institution's management and composite ratings should reflect the examiner's conclusions regarding the institution's internal audit function. The report of inspection should contain comments concerning the adequacy of this function, significant issues or concerns, and recommended corrective actions.

2060.05.4.3 Concerns About the Independence of the Outsourcing Vendor

An examiner's initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, may raise questions about the institution's and its vendor's adherence to the independence standards described in parts I and II of the policy statement, whether or not the vendor is an accounting firm, and in part III if the vendor provides both external and internal audit services to the institution. In such cases, the examiner first should ask the institution and the outsourcing vendor how the audit committee determined that the vendor was independent. If the vendor is an accounting firm, the audit committee should be asked to demonstrate how it assessed that the arrangement has not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence. If the examiner's concerns are not adequately addressed, the examiner should discuss the matter with appropriate agency staff prior to taking any further action.

If the agency staff concurs that the independence of the external auditor or other vendor appears to be compromised, the examiner will discuss his or her findings and the actions the agency may take with the institution's senior management, board of directors (or audit committee), and the external auditor or other vendor. In addition, the agency may refer the external auditor to the state board of accountancy, the AICPA, the SEC, the PCAOB, or other authorities for possible violations of applicable independence standards. Moreover, the agency may conclude that the institution's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including sections 36 and 39 of the FDI Act and related guidance and regulations, if applicable.

2060.05.5 INSPECTION OBJECTIVES

1. To determine with reasonable assurance whether the institution[23] has an adequate system of internal controls that ensures efficient and effective operations, including the safeguarding of assets, reliable financial reporting, and compliance with applicable laws and regulations.
2. To determine if the internal audit function and the internal audit outsourcing arrangements of the banking organizations are adequately and competently managed by the board of directors and senior management.

23. The term ''institution'' is used to maintain consistency with the interagency policy statement, but these inspection objectives and procedures apply to financial holding companies, bank holding companies, and their bank and nonbank subsidiaries.

3. To ascertain that the banking organization's internal audit function monitors, reviews, and ensures the continued existence and maintenance of sound and adequate internal controls over the management process: the control environment, risk assessment, control activities, information and communication, and monitoring activities.
4. To make an overall determination as to whether an institution's internal audit function and its processes are effective or ineffective based on the 2003 interagency policy statement and the FR supplemental policy guidance.
5. To determine whether the internal audit function reports vital information about weaknesses in the system of internal control to the board of directors (or its audit committee) and senior management and that expeditious remedial action is taken to resolve the internal control weaknesses as well as any other exceptions.
6. To determine if
   a. the audit committee has established and maintains procedures for employees of the institution to confidentially and anonymously submit concerns to the committee about questionable accounting, internal control, or auditing matters; and
   b. the audit committee has procedures for the timely investigation of complaints received and the retention, for a reasonable time period, of documentation concerning the complaint and its subsequent resolution.
7. To determine the adequacy of the internal audit function (including its use of outsourced internal audit vendors) as to organizational structure, prudent management, staff having sufficient expertise, audit quality, and the ability of auditors to directly and freely communicate internal audit findings to the board of directors, its audit committee, and senior management.
8. To review and evaluate internal audit outsourcing arrangements and the actions of the outsourcing vendor, under standards established in the 2003 "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" and the 2013 Federal Reserve's "Supplemental Policy Statement on the Internal Audit Function and its Outsourcing."
9. To determine whether the internal audit function and its processes can be relied upon for the current supervisory review period.
10. For high risk areas, to make a determination as to whether additional inspection work is needed even when the internal audit may be deemed effective and its work reliable.

2060.05.6 INSPECTION PROCEDURES

Examiners should obtain assurances from the audit committee and senior management that they will have full and timely access to an institution's internal audit resources, including personnel, work papers, risk assessments, work plans, programs, reports, and budgets. Examiners should consider widening the scope of their inspection work when such assurances are not provided or if there are any significant delays in gaining access to the internal audit resources. Such a delay may subject the institution to follow-up supervisory action.

This inspection program should include a review of audit function and audit outsourcing, which would include a review of the holding company's internal and external audits and the audit procedures they encompass. The audit guidelines are general and all sections or questions may not be applicable to every entity within the consolidated organization.

Before reviewing any specific audit procedures, the examiner should first determine the independence and competence of the auditors. If the examiner believes the auditors to be both competent and independent, he or she should then determine the effectiveness and adequacy of their work, and whether the auditors made an assessment as to whether the institution's internal audit function incorporated the enhanced practices outlined in the FR's "Supplemental Policy Statement on Internal Audit Function and its Outsourcing" (Supplemental Guidance).

Based on a review of the audit function and on the auditor's work, the examiner must then determine the scope of the inspection. The program and related supporting documentation should be completed in an organized manner and should be retained as part of the inspection work papers.

Upon completion of the review of the internal audit program, the examiner should be able to formulate a conclusion on the effectiveness of audit processes and coverage. Conclusions about any weaknesses in the internal or external audit work performed for the FR supervised bank or savings and loan holding company should be summarized and included in the inspection report. Matters Requiring Immediate Attention (MRIA) or Matters Requiring Attention (MRA) to be included in the inspection report should be discussed with the audit committee and board of directors, the Chief Audit Executive, (CAE) and senior bank management.

2060.05.6.1 Internal Audit Function

The following inspection procedures should encompass a review of the structure of the internal audit organization and function:

1. *Organizational structure of the audit department.* Review the internal audit's charter and its organization chart for direct and indirect reporting lines of the CAE, and the minutes of the board's audit or examining committee to determine how effectively the CAE and board of directors are discharging their responsibility. If the CAE reports to someone other than the chief executive officer (CEO), determine if the audit committee has documented its rationale for the reporting structure, including any mitigating controls for situations that could adversely impact the objectivity of the CAE. Determine if the audit committee has quarterly, but at least annually, evaluated whether (1) the CAE is impartial and not unduly influenced by the administrative reporting line and (2) any conflicts of interest for the CAE and other audit staff are accompanied by appropriate restrictions to mitigate those conflicts.
2. *Independence of the audit function.* Interview the CAE and observe the operation of the audit department to determine its functional responsibilities.
3. *CAE's qualifications.* Review biographical data and interview the CAE to determine his or her ability to manage the institution's internal audit function and his or her responsibility within the institution (i.e., bank holding or savings and loan holding company).
4. *Audit staff qualifications.* Review the biographical data and interview the management staff of the audit department to determine their qualifications commensurate with their delegated responsibilities compared to the institution's strategy and operations. Review the educational background, professional certifications and relevant banking and audit experience of staff to assess overall staff qualifications and to identify any knowledge gaps.
5. *Skills gap assessments.* Review how often they are performed, and how gaps in coverage are addressed (e.g. targeted staff hires; training; business- line rotation programs, and co-sourcing/ outsourcing arrangements).
6. *Training.* Ensure there is a process in place to determine and monitor the annual training, typically 40 hours minimum, for each staff member based on their needs.
7. *Content and use of the audit frequency and scope schedule.* Review the methodology utilized to determine the audit universe and frequency of coverage per auditable entity.
8. *Audit department participation in systems design projects.* Determine through interviews and documentation reviews, internal audit's role in assessing systems change control processes.
9. *Internal audit charter.* Review the internal audit charter to determine its current adequacy. Determine whether the CAE periodically reviews the current adequacy of the charter and makes recommendations to the audit committee for improving internal audit function and whether outsourcing to external experts may be needed.
10. *Audit manual.* Review the audit manual to ensure that it includes all applicable audit processes, practices, and procedures, and applicable references to Institute of Internal Auditor (IIA) standards.
11. *Maintenance of audit records.* Review a sample of the audit reports and associated work papers to determine compliance with prescribed procedures and proper documentation, including appropriate distribution to senior managers.
12. *Audit department's formal reporting procedures.* Review CAE presentations and MIS reporting to the audit or examining committee to ensure the committee is providing effective oversight of the internal audit function.
13. *Issue Tracking Follow-up Processes.* Review processes utilized to validate closure of internal audit findings. Review a sample of closed issues to ensure that internal audit maintains sufficient documentation to validate issue closure.

14. *Use and effectiveness of audit computer programs.* Interview the CAE and/or the appropriate staff members regarding the use of the computer and access to the files for audit purposes. Obtain a walkthrough of automated auditing systems and methodologies.

2060.05.6.2 Other Internal Audit Function Inspection Procedures

1. Broaden the scope of the inspection if the institution's internal audit function, whether or not it is outsourced, does not sufficiently meet its internal audit needs, does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, or is otherwise inadequate.
2. Discuss supervisory concerns and outstanding internal-external audit report comments with the CAE or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's comments and concerns, bring these matters to the attention of senior management and the board of directors or audit committee.
3. If material weaknesses in the internal audit function or the internal control system exist, discuss them with appropriate Federal Reserve Bank supervisory staff to determine the appropriate actions that should be taken to ensure that the institution corrects the deficiencies (including formal and informal enforcement actions).
4. Incorporate conclusions about the institution's internal audit function into its management and composite supervisory ratings.
5. Include in the inspection report comments concerning the adequacy of the internal audit function, significant issues or concerns, and recommended corrective actions.

2065.05.6.3 Additional Aspects of the Examiner's Review of an Outsourcing Arrangement

1. Review the internal audit outsourcing arrangement and determine if the institution has a written contract or an engagement letter with the vendor.
2. Determine whether the written contract or engagement letter includes provisions that—
   a. define the expectations and responsibilities under the contract for both parties;
   b. set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
   c. set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
   d. establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and establish stipulations for default and termination of the contract;
   e. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related work papers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the work papers prepared by the outsourcing vendor;
   f. specify the locations of internal audit reports and the related work papers;
   g. specify the period of time (for example, seven years) that vendors must maintain the work papers;[24]
   h. state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related work papers prepared by the outsourcing vendor;
   i. prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence; and
   j. state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, SEC, PCAOB, or regulatory independence guidance.
3. Determine whether—
   a. the outsourcing arrangement maintains or improves the quality of the internal

24. If the work papers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the banking organization and examiners to access the electronic work papers for a specified time period.

audit function and the institution's internal control;

b. key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
c. the scope of work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
d. the directors have ensured that the outsourced internal audit function is effectively managed by the institution;
e. the arrangement with the outsourcing vendor satisfies the independence standards described in the Policy Statement on the Internal Audit Function and Its Outsourcing and thereby preserves the independence of the internal audit function, whether or not the vendor is also the institution's independent public accountant;
f. the institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and whether there are adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement; and
g. the institution has a contingency plan to ensure continuity in audit coverage, especially for high-risk areas.

4. Adjust the scope of the inspection if the outsourcing arrangement has diminished the quality of the institution's internal audit. If the quality of the internal audit is diminished, inform senior management and the board of directors and consider it in the institution's management and composite ratings.

2060.05.6.4 Assessment of Auditor Independence

1. The initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, may raise questions about the institution's and its vendor's adherence to the independence standards discussed in parts I, II, and III of the "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" (2003 Policy Statement) and the Federal Reserve's 2013 Supplemental Guidance. If the vendor provides both external and internal audit services to the institution—
   a. question the bank or savings and loan holding company's CAE and audit committee how they determined that the vendor was independent; and
   b. if the vendor is an accounting firm, ask the CAE or audit committee how they assessed that the arrangement had not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence.
2. If the answers to the above raise supervisory concern, or are not adequately addressed, discuss the matter with appropriate Reserve Bank management and supervisory staff.
3. If the Reserve Bank management and supervisory staff concurs that the independence of the external auditor or other vendor appears to be compromised, discuss the inspection findings and what appropriate supervisory actions the Federal Reserve may take with the bank holding or savings and loan holding company's senior management, board of directors (or audit committee), and the external auditor or other vendor.

2060.05.6.5 Supplemental Procedures to Evaluate the Effectiveness of the Internal Audit Function

1. Determine whether the internal audit function and its processes are effective or ineffective and whether internal audit's work can be potentially relied upon as part of the supervisory review process. An institution's internal audit function generally would be considered effective if the institution's internal audit function structure and practices are consistent with the 2003 interagency policy statement and the Federal Reserve's 2013 supplemental guidance (supplemental guidance).
2. To determine if the institution has incorporated the Federal Reserve's Supplemental Guidance, evaluate whether the factors and requirements underpinning the following characteristics and processes are in place:
   Attributes
   - Independence
   - Competent internal audit staff
   - Objectivity and ethics

Governance

- Role of board of directors
- Role of audit committee
- Role of Chief Audit Executive (CAE)

Audit Processes

- *Audit methodology*—Review the internal audit's risk-assessment methodology that drives its risk-assessment process and determine if it represents the audit universe. Determine if the methodology included a documented analysis of cross-institutional risk and thematic control issues and the processes and procedures for evaluating the effectiveness of risk-management, control, and governance processes. Evaluate internal audit's plan for continuous monitoring and in determining and evaluating risk. Assess internal audit's process for incorporating other risk identification techniques (i.e., risk and control self-assessment) that the institution's management utilizes.
- *Audit universe*—Determine if internal audit has effective processes to identify all auditable entities within the audit universe. Review the documentation of the audit universe and verify whether it has been reviewed periodically (e.g., during the annual audit planning process) and when significant organizational changes have occurred.
- *Risk assessment*—Review internal audit's documentation of its understanding of the institution's significant business activities and their associated risks. Verify that internal audit includes, at least annually, a review of critical risk-management functions as well as changes in the system of internal controls, infrastructure, work processes, new or changed business lines, or laws and regulations. Review the disposition of the results of the overall risk assessment summary and determine if internal audit gave consideration to key performance or risk indicators and the most significant risks facing the institution, including how the risks are addressed within the internal audit plan.
- *Audit plan*—Verify that internal audit develops and periodically revises its comprehensive audit plan. Determine if it verifies that the plan includes audit coverage for all identified, auditable entities within the audit universe appropriate for the size and complexity of the institution's activities.
- *Continuous monitoring*— Supplement inspection procedures with continuous monitoring and an assessment of key elements of internal audit, including:
  — the adequacy and independence of the audit committee;
  — the independence, professional competence, and quality of the internal audit function;
  — the quality and scope of the audit methodology, audit plan, and risk assessment; and
  — the adequacy of audit programs and work paper standards.
  1) Review these key elements at least annually to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding their adequacy.
  2) Make a determination on whether the work of internal audit can be relied upon when internal audit's overall function and related processes are effective and when recent work was performed by internal audit in an area where examiners are performing inspection procedures.
  3) Evaluate and determine whether additional inspection work is needed in high risk areas even where internal audit has been deemed effective and its work reliable.

Audit Performance and Monitoring

- *Scope*—Adjust the scope of the inspection if the bank holding or savings and loan holding company's internal audit function does not sufficiently meet the institution's internal audit needs (whether or not the audit function is outsourced), or is otherwise ineffective.
- *Work papers*—Determine whether the internal audit work papers adequately document the work program, the work performed and work paper standards, including documentation of any observations and analysis made, the conclusions, and audit results.
- *Audit reports:*

1) Ascertain whether internal audit has effective audit reporting processes that communicate audit report issues throughout the institution and they are addressed in a timely manner.
2) Review the inspection period's audit reports and verify that they contain an executive summary describing the auditable area, its conclusions, rationale, key issues, and management's documented action plans to address audit findings.

- *Audit issues tracking*
  1) Verify that internal audit has effective processes in place to track, monitor, and follow up on open audit issues.
  2) Determine if the institution conducts independent quality assurance reviews of internal audit work performed.
  3) Verify that the CAE implements appropriate improvements in internal audit processes or staff training through the quality assurance and improvement programs.
  4) Determine whether the institution conducts an internal quality assessment at least annually and if the CAE reports the results and status of internal assessments to senior management and the audit committee at least annually.
  5) Discuss supervisory concerns and outstanding internal-external audit report comments with the CAE or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's comments and concerns, bring these matters to the attention of senior management and the board of directors or the audit committee.
- *Retrospective review processes.*
  1) Determine if management has conducted a post-mortem and "lessons learned" analysis when adverse events (fraud or a significant loss) have occurred.
  2) Find out if internal audit function verified that a review took place and that appropriate action was taken to remediate identified issues.
  3) Ascertain if internal audit function evaluated management's analysis of the reasons for the event and if the adverse event was the result of a control break down or failure, and whether management identified measures to be put in place to prevent a similar event from occurring in the future.

Quality Assurance

— *Internal Quality Assurance.* Ensure that the internal audit function process is documented in the audit manual. Review samples of work, overall results and status of any action plans.

— *External Quality Assurance.* Determine whether an independent assessment had been performed within the five-year requirement. Review results and action plan status to remediate issues.

1) Assess the quality and scope of the internal audit work, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Consider whether—
   a. the internal audit function's risk assessment, plans, and programs are appropriate for the institution's activities;
   b. the internal audit function is adequately managed to ensure that audit plans are accomplished, programs are carried out, and results of audits are promptly communicated to the managers and directors;
   c. the internal audit plan and program have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
   d. the activities of internal audit are consistent with the long-range goals of the institution and are responsive to its internal control needs; and
   e. the audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

3. If there are deficiencies in any internal audit characteristics, use your judgment to:
   - evaluate the significance of the deficiencies and their relevance to the institution's safety and soundness or compliance with laws and regulations, and
   - determine whether these deficiencies would preclude overall audit processes from being deemed effective.

   While the internal audit function's overall processes could be deemed effective, some elements of the internal audit function may require enhancements or improvements, such as documentation with respect to specific audit processes (for example, risk assessments or work papers).
4. If examiners find the key elements of the internal audit function to be insufficient, the overall effectiveness of the internal audit function should come into question. Such findings may be include:
   - Lack of an appropriate risk-assessment process
   - Lack of sufficient and competent resources
   - Lack of audit coverage in key areas
   - Inappropriate classification of audit findings
   - Insufficient root cause analyses
   - Numerous work paper deficiencies
   - A large number of unresolved control-related issues
5. Internal audit processes may be considered ineffective if there are significant, unresolved supervisory matters requiring immediate attention (MRIAs) and/or matters requiring attention (MRAs) pertaining to internal audit, or if other supervisory concerns exist relating to the effectiveness of the internal audit function.

2060.05.6.6 Continuous Monitoring between Inspections of Internal Audit

1. Supplement the inspection procedures through continuous monitoring. Include an assessment of key elements of internal audit during the period following the institution's most recent inspection. The assessment of key elements of internal audit should include:
   - The adequacy and independence of the audit committee;
   - The independence, professional competence, and quality of the internal audit function;
   - The quality and scope of the audit methodology, audit plan, and risk assessment; and
   - The adequacy of audit programs and work paper standards.
2. Review, at least annually, the above key elements and determine whether there have been significant changes to the internal audit infrastructure or whether there are potential concerns regarding their adequacy.

2060.05.6.7 Evaluating the Ability to Rely on Internal Audit

1. Consider relying on internal audit at a supervised institution based on whether:
   a. an internal audit was deemed effective at the most recent supervisory inspection of internal audit;
   b. internal audit's overall function and related processes are considered effective and when recent work was performed by internal audit in a area where examiners are performing inspection procedures and the examiners can evaluation whether they may rely on the work of internal audit;
   c. an evaluation was performed of the significance and degree of risk of particular activities, business lines or other areas or business and if a determination was made as to the existence of appropriate internal controls over such risks; and
   d. the extent of continuous monitoring activities that did not identify any significant deficiencies or discover any adverse changes in audit processes or the quality of internal audit's work.
2. Leverage off an internal audit function's assessment of how emerging risks and high-risk areas are mitigated within the institution, including whether appropriate internal controls are in place over such risks;
3. For emerging risks and high-risk areas, determine if additional inspection work is needed, even when internal audit has been deemed effective and its work considered reliable.
4. Document the results of the supervisory review, supporting the basis for a conclusion as to whether the examiners can rely upon internal audit and whether there are any specific auditable areas (that is, function or business line) or elements of internal

audit (e.g. open audit issues) on which the examiners cannot rely.

2060.05.6.8 Considerations for Consolidated Supervision

1. Tailor the nature and scope of the Federal Reserve's supervisory and inspection work to the organization's legal entity and regulatory structure and also the risks associated with the organization's activities. Promote effective consolidated supervision by fostering strong, cooperative relationships among the Federal Reserve, relevant domestic and foreign supervisors, and functional regulators. Achieve this objective while limiting the potential for duplication of effort or undue burden on the institution under review.
2. Focus on the scope and depth of the other supervisor's or regulator's internal audit review. Determine the Federal Reserve's ability to rely on the work of the relevant supervisor or functional regulator:
   - Rely to the fullest extent possible on assessments and information developed by other relevant domestic and foreign supervisors and functional regulators;
   - Focus Federal Reserve supervisory attention on material risks from activities that are not supervised by another supervisor or regulator, or that cut across legal entities; and
   - Participate in the exchange of information among domestic and foreign supervisors and functional regulators, consistent with applicable laws and information-sharing arrangements, providing for the comprehensive, consolidated supervision of each banking organization's global activities.
3. The Federal Reserve's conduct of consolidated supervision is central to and dependent on the coordination with, and reliance on, the work of other relevant primary supervisors and functional regulators. The Federal Reserve's direction for achieving these objectives is closely integrated into the supervisory framework for consolidated bank holding companies and the combined U.S. operations of foreign banking organizations.
4. When the Federal Reserve is not the primary supervisor or functional regulator of all entities consolidated under the holding company, the Federal Reserve will evaluate whether, and the degree to which, the major subsidiaries of the holding company implemented the supplemental guidance.

The Federal Reserve issued this January 23, 2013, policy statement to supplement the guidance in the 2003 "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" (referred to as the 2003 Policy Statement).[1] Federal Reserve staff has identified areas for improving regulated institutions' internal audit functions. This supplemental policy statement addresses the characteristics, governance, and operational effectiveness of an institution's internal audit function. Further, this statement reflects certain changes in banking regulations that have occurred since the issuance of the 2003 Policy Statement. The Federal Reserve is providing this supplemental guidance to enhance regulated institutions' internal audit practices and to encourage them to adopt professional audit standards and other authoritative guidance, including those issued by the Institute of Internal Auditors (IIA).[2]

This supplemental statement applies to supervised institutions with greater than $10 billion in total consolidated assets, including state member banks, domestic bank and savings and loan holding companies, and U.S. operations of foreign banking organizations.[3] This supplemental guidance is also consistent with the objectives of the Federal Reserve's consolidated supervision framework for large financial institutions with total consolidated assets of $50 billion or more, which promotes an independent internal audit function as an essential element for enhancing the resiliency of supervised institutions.[4]

Assessment of the effectiveness of the internal audit function. The degree to which an institution implements the internal audit practices outlined in this policy statement will be considered in the Federal Reserve's supervisory assessment of the effectiveness of an institution's internal audit function as well as its safety and soundness and compliance with consumer laws and regulations. Moreover, the overall effectiveness of an institution's internal audit function will influence the ability of the Federal Reserve to rely upon the work of an institution's internal audit function.

This supplemental policy statement builds upon the 2003 Policy Statement, which remains in effect, and follows the same organizational structure, with a new section entitled "Enhanced Internal Audit Practices" and updates to Parts I-IV of the 2003 Policy Statement. Refer to SR-13-1/CA13-1 and its attachment. To avoid historical references and duplication some introductory paragraphs and other small phrases are omitted from the policy statement here, as indicated by a line of asterisks.

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2060.07.1 SUPPLEMENTAL POLICY GUIDANCE

2060.07.1.1 Enhanced Internal Audit Practices

An institution's internal audit function should incorporate the following enhanced practices into their overall processes:

2060.07.1.1.1 Risk Analysis

Internal audit should analyze the effectiveness of all critical risk-management functions both with respect to individual risk dimensions (for example, credit risk), and an institution's overall risk-management function. The analysis should focus on the nature and extent of monitoring compliance with established policies and processes and applicable laws and regulations within the institution as well as whether monitoring processes are appropriate for the institution's business activities and the associated risks.

2060.07.1.1.2 Thematic Control Issues

Internal audit should identify thematic macro control issues as part of its risk-assessment pro-

1. Refer to SR-03-5, "Amended Interagency Guidance on the Internal Audit Function and Its Outsourcing."

2. In this guidance, references have been provided to the IIA's International Standards for the Professional Practice of Internal Auditing (Standards). Refer to the IIA website at https://na.theiia.org/standards-guidance/pages/standards-and-guidance-ippf.aspx.

3. Section 4 of this document, however, clarifies certain changes to the Federal Deposit Insurance Corporation regulation (12 CFR part 363) on independence standards for independent public accountants at insured depository institutions with total assets of $500 million or more, which were adopted pursuant to 2009 amendments to section 36 of the FDI Act.

4. Refer to SR-12-17/CA letter 12-14, "Consolidated Supervision Framework for Large Financial Institutions."

cesses and determine the overall impact of such issues on the institution's risk profile. Additional audit coverage would be expected in business activities that present the highest risk to the institution. Internal audit coverage should reflect the identification of thematic macro control issues across the firm in all auditable areas. Internal audit should communicate thematic macro control issues to senior management and the audit committee.

In addition, internal audit should identify patterns of thematic macro control issues, determine whether additional audit coverage is required, communicate such control deficiencies to senior management and the audit committee, and ensure management establishes effective remediation mechanisms.

2060.07.1.1.3 Challenging Management and Policy

Internal audit should challenge management to adopt appropriate policies and procedures and effective controls. If policies, procedures, and internal controls are ineffective or insufficient in a particular line of business or activity, internal audit should report specific deficiencies to senior management and the audit committee with recommended remediation. Such recommendations may include restricting business activity in affected lines of business until effective policies, procedures, and controls are designed and implemented. Internal audit should monitor management's corrective action and conduct a follow-up review to confirm that the recommendations of both internal audit and the audit committee have been addressed.

2060.07.1.1.4 Infrastructure

When an institution designs and implements infrastructure enhancements, internal audit should review significant changes and notify management of potential internal control issues. In particular, internal audit should ensure that existing, effective internal controls (for example, software applications and management information system reporting) are not rendered ineffective as a result of infrastructure changes unless those controls are compensated for by other improvements to internal controls.

2060.07.1.1.5 Risk Tolerance

Internal audit should understand risks faced by the institution and confirm that the board of directors and senior management are actively involved in setting and monitoring compliance with the institution's risk tolerance limits. Internal audit should evaluate the reasonableness of established limits and perform sufficient testing to ensure that management is operating within these limits and other restrictions.

2060.07.1.1.6 Governance and Strategic Objectives

Internal audit should evaluate governance at all management levels within the institution, including at the senior management level, and within all significant business lines. Internal audit should also evaluate the adequacy and effectiveness of controls to respond to risks within the organization's governance, operations, and information systems in achieving the organization's strategic objectives. Any concerns should be communicated by internal audit to the board of directors and senior management.

2060.07.1.2 Internal Audit Function *(Part I of the 2003 Policy Statement)*

The primary objectives of the internal audit function are to examine, evaluate, and perform an independent assessment of the institution's internal control system, and report findings back to senior management and the institution's audit committee. An effective internal audit function within a financial institution is a vital means for an institution's board of directors to maintain the quality of the internal control environment and risk-management systems.

The guidance set forth in this section supplements the existing guidance in the 2003 Policy Statement by strongly encouraging internal auditors to adhere to professional standards, such as the IIA guidance. Furthermore, this section clarifies certain aspects of the IIA guidance and provides practices intended to increase the safety and soundness of institutions.

2060.07.1.2.1 Attributes of Internal Audit

Independence. Internal audit is an independent function that supports the organization's business objectives and evaluates the effectiveness of risk management, control, and governance processes. The 2003 Policy Statement addressed the structure of an internal audit function, noting that it should be positioned so that an institution's board of directors has confidence that the internal audit function can be impartial and not unduly influenced by managers of day-to-day operations. Thus, the member of management responsible for the internal audit function (hereafter referred to as the chief audit executive or CAE)[5] should have no responsibility for operating the system of internal control and should report functionally to the audit committee. A reporting arrangement may be used in which the CAE is functionally accountable and reports directly to the audit committee on internal audit matters (that is, the audit plan, audit findings, and the CAE's job performance and compensation) and reports administratively to another senior member of management who is not responsible for operational activities reviewed by internal audit. When there is an administrative reporting of the CAE to another member of senior management, the objectivity of internal audit is served best when the CAE reports administratively to the chief executive officer (CEO).

If the CAE reports administratively to someone other than the CEO, the audit committee should document its rationale for this reporting structure, including mitigating controls available for situations that could adversely impact the objectivity of the CAE. In such instances, the audit committee should periodically (at least annually) evaluate whether the CAE is impartial and not unduly influenced by the administrative reporting line arrangement. Further, conflicts of interest for the CAE and all other audit staff should be monitored at least annually with appropriate restrictions placed on auditing areas where conflicts may occur.

For foreign banking organizations (FBOs), the internal audit function for the U.S. operations of an FBO should have appropriate independent oversight for the total assets of U.S. operations.[6] When there is a resident U.S. audit function, the CAE of the U.S. audit function should report directly to senior officials of the internal audit department at the head office such as the global CAE. If the FBO has separate U.S. subsidiaries, oversight may be provided by a U.S. based audit committee that meets U.S. public company standards for independence or by the foreign parent company's internal audit function.

Professional competence and staffing. Internal audit staff should have the requisite collective skill levels to audit all areas of the institution. Therefore, auditors should have a wide range of business knowledge, demonstrated through years of audit and industry-specific experience, educational background, professional certifications, training programs, committee participation, professional associations, and job rotational assignments. Internal audit should assign staff to audit assignments based on areas of expertise and, when feasible, rotate staff within the audit function.

Internal audit management should perform knowledge-gap assessments at least annually to evaluate whether current staff members have the knowledge and skills commensurate with the institution's strategy and operations. Management feedback surveys and internal or external quality assurance findings are useful tools to identify and assess knowledge gaps. Any identified knowledge gaps should be filled and may be addressed through targeted staff hires, training, business line rotation programs, and outsourcing arrangements. The internal audit function should have an effective staff training program to advance professional development and should have a process to evaluate and monitor the quality and appropriateness of training provided to each auditor. Internal auditors generally receive a minimum of forty hours of training in a given year.

Objectivity and ethics. Internal auditors should be objective, which means performing assignments free from bias and interference. A major characteristic of objectivity is that the CAE and all internal audit professional staff avoid any conflicts of interest.[7] For their first year in the internal audit function, internally recruited internal auditors should not audit activities for which they were previously responsible. Moreover, compensation schemes should not provide incentives for internal auditors to act contrary to the attributes and objectives of the internal audit

5. More recently, this title is used to refer to the person in charge of the internal audit function. An institution may not have a person at the management level of CAE and instead may have an internal audit manager.

6. This is defined as the combined total assets of U.S. operations, net of all intercompany assets and claims on U.S.-domiciled affiliates.

7. IIA standards define conflict of interest as a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult for the individual to fulfill his or her duties impartially.

function.[8] While an internal auditor may recommend internal control standards or review management's procedures before implementation, objectivity requires that the internal auditor not be responsible for the design, installation, procedures development, or operations of the institution's internal control systems.

An institution's internal audit function should have a code of ethics that emphasizes the principles of objectivity, competence, confidentiality, and integrity, consistent with professional internal audit guidance such as the code of ethics established by the IIA.

Internal audit charter. Each institution should have an internal audit charter that describes the purpose, authority, and responsibility of the internal audit function. An audit charter should include the following critical components:

- The objectives and scope of the internal audit function;
- The internal audit function's management reporting position within the organization, as well as its authority and responsibilities;
- The responsibility and accountability of the CAE; and
- The internal audit function's responsibility to evaluate the effectiveness of the institution's risk management, internal controls, and governance processes.

The charter should be approved by the audit committee of the institution's board of directors. The charter should provide the internal audit function with the authorization to access the institution's records, personnel, and physical properties relevant to the performance of internal audit procedures, including the authority to examine any activities or entities. Periodically, the CAE should evaluate whether the charter continues to be adequate, requesting the approval of the audit committee for any revisions. The charter should define the criteria for when and how the internal audit function may outsource some of its work to external experts.

8. IIA standards have additional examples of "conflict of interest" for consideration.

2060.07.1.2.2 Corporate Governance Considerations

Board of directors and senior management responsibilities. The board of directors and senior management are responsible for ensuring that the institution has an effective system of internal controls. As indicated in the 2003 Policy Statement, this responsibility cannot be delegated to others within the institution or to external parties. Further, the board of directors and senior management are responsible for ensuring that internal controls are operating effectively.

Audit committee responsibilities. An institution's audit committee is responsible for establishing an appropriate internal audit function and ensuring that it operates adequately and effectively. The audit committee should be confident that the internal audit function addresses the risks and meets the demands posed by the institution's current and planned activities. Moreover, the audit committee is expected to retain oversight responsibility for any aspects of the internal audit function that are outsourced to a third party.

The audit committee should provide oversight to the internal audit function. Audit committee meetings should be on a frequency that facilitates this oversight and generally should be held four times a year at a minimum, with additional meetings held by audit committees of larger financial institutions. Annually, the audit committee should review and approve internal audit's charter, budget and staffing levels, and the audit plan and overall risk-assessment methodology. The committee approves the CAE's hiring, annual performance evaluation, and compensation.

The audit committee and its chairperson should have ongoing interaction with the CAE separate from formally scheduled meetings to remain current on any internal audit department, organizational, or industry concerns. In addition, the audit committee should have executive sessions with the CAE without members of senior management present as needed.

The audit committee should receive appropriate levels of management information to fulfill its oversight responsibilities. At a minimum, the audit committee should receive the following data with respect to internal audit:

- Audit results with a focus on areas rated less than satisfactory;
- Audit plan completion status and compliance with report issuance timeframes;

- Audit plan changes, including the rationale for significant changes;
- Audit issue information, including aging, past-due status, root-cause analysis, and thematic trends;
- Information on higher-risk issues indicating the potential impact, root cause, and remediation status;
- Results of internal and external quality assurance reviews;
- Information on significant industry and institution trends in risks and controls;
- Reporting of significant changes in audit staffing levels;
- Significant changes in internal audit processes, including a periodic review of key internal audit policies and procedures;
- Budgeted audit hours versus actual audit hours;
- Information on major projects; and
- Opinion on the adequacy of risk-management processes, including effectiveness of management's self-assessment and remediation of identified issues (at least annually).

Role of the chief audit executive. In addition to communicating and reporting to the audit committee on audit-related matters, the CAE is responsible for developing and maintaining a quality assurance and improvement program that covers all aspects of internal audit activity, and for continuously monitoring the effectiveness of the audit function. The CAE and/or senior staff should effectively manage and monitor all aspects of audit work on an ongoing basis, including any audit work that is outsourced.[9]

2060.07.1.2.3 The Adequacy of the Internal Audit Function's Processes

Internal audit should have an understanding of the institution's strategy and operating processes as well as the potential impact of current market and macroeconomic conditions on the financial institution. Internal audit's risk-assessment methodology is an integral part of the evaluation of overall policies, procedures, and controls at the institution and the development of a plan to test those processes.

Audit methodology. Internal audit should ensure that it has a well-developed risk-assessment methodology that drives its risk-assessment process. The methodology should include an analysis of cross-institutional risk and thematic control issues and address its processes and procedures for evaluating the effectiveness of risk management, control, and governance processes. The methodology should also address the role of continuous monitoring in determining and evaluating risk, as well as internal audit's process for incorporating other risk identification techniques that the institution's management utilizes such as a risk and control self-assessment (RCSA). The components of an effective methodology should support the internal audit function's assessment of the control environment, beginning with an evaluation of the audit universe.

Audit universe. Internal audit should have effective processes to identify all auditable entities within the audit universe. The number of auditable entities will depend upon whether entities are captured at individual department levels or at other aggregated organizational levels. Internal audit should use its knowledge of the institution to determine whether it has identified all auditable entities and may use the general ledger, cost centers, new product approval processes, organization charts, department listings, knowledge of the institution's products and services, major operating and application systems, significant laws and regulations, or other data. The audit universe should be documented and reviewed periodically as significant organizational changes occur or at least during the annual audit planning process.

Internal audit risk assessment. A risk assessment should document the internal audit staff's understanding of the institution's significant business activities and the associated risks. These assessments typically analyze the risks inherent in a given business line or process, the mitigating control processes, and the resulting residual risk exposure to the institution.

A comprehensive risk assessment should effectively analyze the key risks (and the critical risk-management functions) within the institution and prioritize audit entities within the audit universe. The risk-assessment process should be well documented and dynamic, reflecting changes to the system of internal controls, infrastructure, work processes, and new or changed

9. The ongoing review of audit work should include risk assessments of audit entities and elements, scope documents, audit programs, detailed audit procedures and steps (including sampling methodologies), audit work papers, audit findings, and monitoring of the timely and effective resolution of audit issues.

business lines or laws and regulations. The risk assessments should also consider thematic control issues, risk tolerance, and governance within the institution. Risk assessments should be revised in light of changing market conditions or laws and regulations and updated during the year as changes are identified in the business activities of the institution or observed in the markets in which the institution operates, but no less than annually. When the risk assessment indicates a change in risk, the audit plan should be reviewed to determine whether the planned audit coverage should be increased or decreased to address the revised assessment of risk.

Risk assessments should be formally documented and supported with written analysis of the risks.[10] There should be risk assessments for critical risk-management functions within the institution. Risk assessments may be quantitative or qualitative and may include factors such as the date of the last audit, prior audit results, the impact and likelihood of an event occurring, and the status of external vendor relationships. A management RCSA, if performed, may be considered by the internal audit function in developing its independent risk assessment. The internal audit risk assessment should also include a specific rationale for the overall auditable entity risk score. The overall disposition of the risk assessment should be summarized with consideration given to key performance or risk indicators and prior audit results. A high-level summary or discussion of the risk-assessment results should be provided to the audit committee and include the most significant risks facing the institution as well as how these risks have been addressed in the internal audit plan.

Internal audit plan. Internal audit should develop and periodically revise its comprehensive audit plan and ensure that audit coverage for all identified, auditable entities within the audit universe is appropriate for the size and complexity of the institution's activities. This should be accomplished either through a multiyear plan approach, with the plan revised annually, or through an approach that utilizes a framework to evaluate risks annually focusing on the most significant risks. In the latter approach, there should be a mechanism in place to identify when a significant risk will not be audited in the specified timeframe and a requirement to notify the audit committee and seek its approval of any exception to the framework. Generally, common practice for institutions with defined audit cycles is to follow either a three- or four-year audit cycle; high-risk areas should be audited at least every twelve to eighteen months.[11]

The internal audit plan should consider the risk assessment and internal audit's approach to audit coverage should be appropriate based on the risk assessment. An effective plan covers individual business areas and risk disciplines as well as cross-functional and cross-institutional areas.

The audit planning process should be dynamic, allowing for change when necessary. The process should include a process for modifying the internal audit plan to incorporate significant changes that are identified either through continuous monitoring or during an audit. Any significant changes should be clearly documented and included in quarterly communications to the audit committee. Critical data to be reported to the audit committee should include deferred or cancelled audits rated high-risk and other significant additions or deletions. Significant changes to audit budgets and timeliness for the completion of audits should be reported to the audit committee with documented rationale.

Internal audit continuous monitoring. Internal audit is encouraged to utilize formal continuous monitoring practices as part of the function's risk-assessment processes to support adjustments to the audit plan or universe as they occur. Continuous monitoring can be conducted by an assigned group or individual internal auditors. An effective continuous monitoring process should include written standards to ensure consistent application of processes throughout the organization.

Continuous monitoring results should be documented through a combination of metrics, management reporting, periodic audit summaries, and updated risk assessments to substantiate that the process is operating as designed. Critical issues identified through the monitoring process should be communicated to the audit committee. Computer-assisted auditing techniques are useful tools to highlight issues that

10. For example, risks include credit, market, operational, liquidity, compliance, IT, fraud, political, legal, regulatory, strategic, and reputational.

11. Regardless of the institution's practice, particular care should be taken to ensure that higher-risk elements are reviewed with an appropriate frequency, and not obscured due to their inclusion in a lower risk-rated audit entity.

warrant further consideration within a continuous monitoring process.

2060.07.1.2.4 Internal Audit Performance and Monitoring Processes

Performance. Detailed guidance related to the performance of an internal audit should be documented in the audit manual[12] and work programs to ensure that audit execution is consistent across the audit function. Internal audit policies and procedures should be designed to ensure that audits are executed in a high-quality manner, their results are appropriately communicated, and issues are monitored and appropriately resolved. In performing internal audit work, an institution should consider the following.

- *Internal audit scope:* During the audit planning process, internal audit should analyze the auditable entity's specific risks, mitigating controls, and level of residual risk. The information gathered during the audit planning phase should be used to determine the scope and specific audit steps that should be performed to test the adequacy of the design and operating effectiveness of control processes.

- *Internal audit work papers:* Work papers document the work performed, observations and analyses made, and support for the conclusions and audit results. The work papers should contain sufficient information regarding any scope or audit program modifications and waiver of issues not included in the final report. Work papers also should document the specific sampling methodology, including minimum sample sizes, and the rationale for such methodology. The work papers should contain information that reflects all phases of the audit process including planning, fieldwork, reporting, and issues tracking and follow-up. On an ongoing basis, a comprehensive supervisory review should be performed on all audit work, including any outsourced internal audit procedures.[13]

- *Audit report:* Internal audit should have effective processes to ensure that issues are communicated throughout the institution and audit issues are addressed in a timely manner. The audit report should include an executive summary that describes the auditable area, audit's conclusions, the rationale for those conclusions, and key issues. Most audit reports also include management's action plans to address audit findings. To ensure that identified issues are addressed in a timely manner, reports should be issued to affected business areas, senior management, and the audit committee within an appropriate timeframe after the completion of field work. Compliance with issuance timeframes should be monitored and reported periodically to the audit committee. At a minimum, internal audit should ensure that management considers the level and significance of the risk when assigning resources to address and remediate issues. Management should appropriately document the action plans either within the audit report or separately.

- *Internal audit issues tracking:* Internal audit should have effective processes in place to track and monitor open audit issues and to follow-up on such issues. The timely remediation of open audit issues is an essential component of an organization's risk reduction efforts. Internal audit and the responsible management should discuss and agree to an appropriate resolution date, based on the level of work necessary to complete remediation processes. When an issue owner indicates that work to close an issue is completed, the internal audit function should perform validation work prior to closing the issue. The level of validation necessary may vary based on the issue's risk level. For higher-risk issues, internal audit should perform and document substantive testing to validate that the issue has been resolved. Issues should be tested over an appropriate period of time to ensure the sustainability of the remediation.

Retrospective review processes. When an adverse event occurs at an institution (for example, fraud or a significant loss), management should conduct a post-mortem and "lessons learned" analysis. In these situations, internal audit should ensure that such a review takes place and appropriate action is taken to remediate identified issues. The internal audit function should evaluate management's analysis of the reasons for the event and whether the adverse

12. To facilitate effective, efficient, and consistent practice within the internal audit department, an institution should develop an audit manual that includes comprehensive policies and procedures and is made available to all internal audit staff. The manual should be updated as needed.

13. An experienced audit manager should perform this review.

event was the result of a control breakdown or failure, and identify the measures that should be put in place to prevent a similar event from occurring in the future. In certain situations, the internal audit function should conduct its own post-mortem and a "lessons learned" analysis outlining the remediation procedures necessary to detect, correct, and/or prevent future internal control breakdowns (including improvements in internal audit processes).

Quality assurance and improvement program. A well-designed, comprehensive quality assurance program should ensure that internal audit activities conform to the IIA's professional standards and the institution's internal audit policies and procedures. The program should include both internal and external quality assessments.

The internal audit function should develop and document its internal assessment program to promote and assess the quality and consistency of audit work across all audit groups with respect to policies, procedures, audit performance, and work papers. The quality assurance review should be performed by someone independent of the audit work being reviewed. Conclusions reached and recommendations for appropriate improvement in internal audit process or staff training should be implemented by the CAE through the quality assurance and improvement program. Action plan progress should be monitored and subsequently closed after a period of sustainability. Each institution should conduct an internal quality assessment annually and the CAE should report the results and status of internal assessments to senior management and the audit committee at least annually.

The IIA recommends that an external quality assessment of internal audit be performed by a qualified independent party at least once every five years. The review should address compliance with the IIA's definition of internal auditing, code of ethics, and standards, as well as with the internal audit function's charter, policies and procedures, and any applicable legislative and regulatory requirements. The CAE should communicate the results, planned actions, and status of remediation efforts to senior management and the audit committee.

2060.07.1.3 Internal Audit Outsourcing Arrangements *(Part II of the 2003 Policy Statement)*

As stated in the 2003 Policy Statement, an institution's board of directors and senior management are charged with the overall responsibility for maintaining an effective system of internal controls. Responsibility for maintaining an effective system of internal controls cannot be delegated to a third party. An institution that chooses to outsource audit work should ensure that the audit committee maintains ownership of the internal audit function. The institution's audit committee and CAE should provide active and effective oversight of outsourced activities. Institutions should carefully consider the oversight responsibilities that are consequential to these types of arrangements in determining appropriate staffing levels.

To distinguish its duties from those of the outsourcing vendor, the institution should have a written contract, which may take the form of an engagement letter or similar services agreement. Contracts between the institution and the vendor should include a provision stating that work papers and any related non-public confidential information and personal information must be handled by the vendor in accordance with applicable laws and regulations. An institution should periodically confirm that the vendor continues to comply with the agreed-upon confidentiality requirements, especially for long-term contracts. The audit committee should approve all significant aspects of outsourcing arrangements and should receive information on audit deficiencies in a manner consistent with that provided by the in-house audit department.

2060.07.1.3.1 Vendor Competence

An institution should have appropriate policies and procedures governing the selection and oversight of internal audit vendors, including whether to continue with an existing outsourced arrangement. The audit committee and the CAE are responsible for the selection and retention of internal audit vendors and should be aware of factors that may impact vendors' competence and ability to deliver high-quality audit services.

2060.07.1.3.2 Contingency Planning

An institution's contingency plan should take into consideration the extent to which the institution relies upon outsourcing arrangements.

When an institution relies significantly on the resources of an internal audit service provider, the institution should have contingency procedures for managing temporary or permanent disruptions in the service in order to ensure that the internal audit function can meet its intended objectives.

2060.07.1.3.3 Quality of Audit Work

The quality of audit work performed by the vendor should be consistent with the institution's standards of work expected to be performed by an in-house internal audit department. Further, information supplied by the vendor should provide the board of directors, its audit committee, and senior management with an accurate report on the control environment, including any changes necessary to enhance controls.

2060.07.1.4 Independence Guidance for the Independent Public Accountant *(Part III of the 2003 Policy Statement)*

The following discussion supplements the discussion in Part III of the 2003 Policy Statement and addresses additional requirements regarding auditor independence for depository institutions subject to section 36 of the FDI Act (as amended in 2009).

2060.07.1.4.1 Depository Institutions Subject to the Annual Audit and Reporting Requirements of Section 36 of the FDI Act

The July 2009 amendments to section 36 of the FDI Act (applicable to insured depository institutions with total assets of $500 million or more) require an institution's external auditor to follow the more restrictive of the independence rules issued by the AICPA, SEC, and PCAOB. In March 2003, the SEC prohibited a registered public accounting firm that is responsible for furnishing an opinion on the consolidated or separate financial statements of an audit client from providing internal audit services to that same client.[14] Therefore, by following the more restrictive independence rules, a depository institution's external auditor is precluded from performing internal audit services, either on a co-sourced or an outsourced basis, even if the institution is not a public company.

14. See SEC final rule, "Strengthening the Commission's Requirements Regarding Auditor Independence," at 17 CFR parts 210, 240, 249 and 274.

2060.07.1.5 Examination Guidance *(Part IV of the 2003 Policy Statement)*

The following discussion supplements the existing guidance in Part IV of the 2003 Policy Statement on examination guidance and discusses the overall effectiveness of an institution's internal audit function and the examiner's reliance on internal audit.

2060.07.1.5.1 Determining the Overall Effectiveness of Internal Audit

An effective internal audit function is a vehicle to advance an institution's safety and soundness and compliance with consumer laws and regulations and is therefore considered as part of the supervisory review process. Federal Reserve examiners will make an overall determination as to whether the internal audit function and its processes are effective or ineffective and whether examiners can potentially rely upon internal audit's work as part of the supervisory review process. If internal audit's overall processes are deemed effective, examiners may be able to rely on the work performed by internal audit depending on the nature and risk of the functions subject to examination.

The supervisory assessment of internal audit and its effectiveness will consider an institution's application of the 2003 Policy Statement and this supplemental guidance. An institution's internal audit function generally would be considered effective if the institution's internal audit function structure and practices are consistent with the 2003 Policy Statement and this guidance.

Conversely, an institution's internal audit function that does not follow the enhanced practices and supplemental guidance outlined in this policy letter generally will be considered ineffective. In such a case, examiners will not rely on the institution's internal audit function.

Examiners will inform the CAE as to whether the function is deemed to be effective or ineffective. Internal audit's overall processes could be deemed effective even though some aspects of the internal audit function may require enhancements or improvements such as additional documentation with respect to specific audit processes (for example, risk assessments or work papers). In these situations, the required enhancements or improvements generally should not be a critical part of the overall internal audit function, or the function should be deemed to be ineffective.

2060.07.1.5.2 Relying on the Work Performed by Internal Audit

Examiners may rely on internal audit at supervised institutions if internal audit was deemed effective at the most recent examination of internal audit. In examining an institution's internal audit function, examiners will supplement their examination procedures through continuous monitoring and an assessment of key elements of internal audit, including (1) the adequacy and independence of the audit committee; (2) the independence, professional competence, and quality of the internal audit function; (3) the quality and scope of the audit methodology, audit plan, and risk assessment; and (4) the adequacy of audit programs and work paper standards. On at least an annual basis, examiners should review these key elements to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding their adequacy.

Examiners may choose to rely on the work of internal audit when internal audit's overall function and related processes are effective and when recent work was performed by internal audit in an area where examiners are performing examination procedures. For example, if an internal audit department performs internal audit work in an area where examiners might also review controls, examiners may evaluate whether they can rely on the work of internal audit (and either eliminate or reduce the testing scheduled as part of the regulatory examination processes). In high-risk areas, examiners will consider whether additional examination work is needed even where internal audit has been deemed effective and its work reliable.

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(End of the January 23, 2013, Supplemental Policy Statement)

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2016, this section has been revised to incorporate the January 15, 2016 "Interagency Advisory on External Audits of Internationally Active U.S. Financial Institutions." The federal banking agencies issued the interagency advisory to communicate their support for the principles and expectations set forth in parts 1 and 2 of the Basel Committee on Banking Supervision's March 2014 guidance on "External audits of banks." "Internationally Active Banks" is defined in the advisory. Refer to subsection 2060.1.8 and SR-16-2 and its attachment.

2060.1.1 INTERNAL AND EXTERNAL AUDIT PROGRAMS AND ACTIVITIES

Audit is an independent appraisal activity that serves as a managerial control within an organization. The primary responsibility for the maintenance of sound systems of internal controls and an adequate internal audit program rests with the directorate of the bank holding company. Included among the objectives of a comprehensive audit program are the detection of irregularities; the determination of compliance with applicable laws and regulations; and the appraisal of the soundness and adequacy of accounting, operating, and administrative controls designed to ensure prompt and accurate recording of transactions and proper safeguarding of assets. At a minimum, an audit program should ensure that adequate systems of checks and balances are in effect to deter fraud and detect control deficiencies.

The size and complexity of a bank holding company operation are major determinants in the scope and extent of the audit program that is developed. In the smaller, less sophisticated organizations, such as holding company shells for small banks, it may not be feasible to employ an auditor or implement an audit program. In some cases, such as those in which banking assets represent virtually all of the parent company's assets and a comprehensive, effective audit program is being implemented in the various subsidiaries, neither an internal nor an external audit program may be necessary at the parent company level.

The development and implementation of an internal audit program should be delegated to a qualified staff large enough to meet the functional requirements of the job under the guidance and leadership of the auditor. When evaluating the effectiveness of an internal audit program, the examiner may want to consider the size of audit staffs of banking organizations of a similar size and complexity. To ensure freedom of access to corporate records and complete independence and objectivity in administering the audit program, the auditor should report directly to the directorate or a committee thereof. Administratively, the internal auditor is usually responsible to an officer at a major policymaking level.

To supplement the internal audit activities, external accountants-auditors may be engaged to certify or audit the financial statements or specified activities of the bank holding company and its subsidiaries. Each top-tier bank holding company with total consolidated assets of $500 million or more must engage independent public accountants to perform audits and report on its annual financial statements in accordance with generally accepted accounting principles. The scope of the audit engagement must be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles. Bank holding companies do not have to submit audited financial statements as part of the requirements for the FR Y-6 annual report. The Federal Reserve may request audited consolidated financial statements from any bank holding company with total consolidated assets of less than $500 million if deemed warranted for supervisory purposes.

The internal and external auditors should work together in establishing the scope and frequency of audits to be performed. In addition to performing some of the basic functions of the internal auditor, the external auditor should review the internal auditing program to assess its scope and adequacy. When a bank holding company is perhaps too small to employ an internal audit staff, but when the complexities and activities of the organization suggest the need for an audit, the holding company should consider hiring an external auditor. Independence and objectivity are mandatory in any audit program, and these are difficult to maintain if the audit function is a part-time responsibility. When external auditors are employed to perform the internal audit function, they should be permitted to establish the scope of their audits and schedule surprise audits. They also should be given responsibility for suggesting systems and organizational duty assignments for maximum control consistent with the size of the organization.

2060.1.2 EXTERNAL AUDITORS AND THE RELEASE OF REQUIRED INFORMATION

The enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) on August 9, 1989, requires that FDIC-insured depository institutions that are being audited provide their independent auditors with information concerning their financial condition and any supervisory actions being taken against them. Specifically, section 36(h)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831m(h)(1)) (the FDI Act) requires an insured depository institution that has engaged the services of an independent auditor to perform an audit within the past two years to provide the auditor with—

1. a copy of the most recent report of condition made by the institution (pursuant to the FDI Act or any other provision of law) and a copy of the most recent report of examination received by the institution;
2. a copy of any supervisory memorandum of understanding with such institution and any written agreement between a federal or state banking agency and the depository institution that is in effect during the period covered by the audit; and
3. a report of any action initiated or taken by a federal banking agency during the period covered by the audit under subsection (a), (b), (c), (e), (g), (i), (s), or (t) of section 8 of the FDI Act or of any similar action taken by a state banking agency under state law, or any other civil money penalty assessed under any other provision of law with respect to the depository institution or any affiliated party.

External auditors who are serving as agents of a bank holding company may, with the approval of the organization, review examination or inspection reports and supervisory correspondence received and communicate with examiners. Examiners should remind external auditors of their responsibility to maintain the confidentiality of the reports and other supervisory communications reviewed as part of their engagement. See also the Board's rules on the release of confidential supervisory information (12 C.F.R. 261, subpart C).

2060.1.3 EXTERNAL AUDITOR INQUIRIES

In some situations, examiners may not be able to fully respond to external auditors' inquiries on certain matters relating to examinations still in progress. The examiners' findings may be incomplete or may be under review by higher supervisory authorities within the Federal Reserve System. In addition, as a general practice, examiners will normally only discuss with external auditors issues and inspection findings that have been presented to the bank holding company's management. These situations relate primarily to the timing of the auditors' inquiries in relation to the stage of inspection work and, thus, should not automatically preclude an auditor from expressing an opinion on the organization's financial statements.

2060.1.4 UNSAFE AND UNSOUND USE OF LIMITATION-OF-LIABILITY PROVISIONS IN EXTERNAL AUDIT ENGAGEMENT LETTERS

On February 9, 2006, the Federal Reserve and the other financial institution regulatory agencies (the agencies)[1] issued an interagency advisory (the advisory) to address safety-and-soundness concerns that may arise when financial institutions enter into external audit contracts (typically referred to as *engagement letters*) that limit the auditors' liability for audit services.[2] The advisory informs financial institutions'[3] boards of directors, audit committees, management, and external auditors of the safety-and-soundness implications that may arise when the financial institution enters into engagement letters that contain provisions to limit the auditors' liability.

1. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

2. The advisory is effective for audit engagement letters issued on or after February 9, 2006.

3. As used in this advisory, the term *financial institutions* includes bank holding companies, banks, savings associations, and savings and loan holding companies.

The advisory does not apply to previously executed engagement letters. However, any financial institution subject to a multiyear audit engagement letter containing unsafe and unsound limitation-of-liability provisions should seek an amendment to its engagement letter to be consistent with the advisory for periods ending in 2007 or later. (See SR-06-4.)

Limits on external auditors' liability may weaken the external auditors' objectivity, impartiality, and performance and, thus, reduce the agencies' ability to rely on audits. Therefore, certain limitation-of-liability provisions (described in the advisory and its appendix A; see section 2060.1.4.7) are unsafe and unsound. In addition, such provisions may not be consistent with the auditor-independence standards of the U.S. Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the American Institute of Certified Public Accountants (AICPA).

2060.1.4.1 Scope of the Advisory on Engagement Letters

The advisory applies to engagement letters between financial institutions and external auditors with respect to financial-statement audits, audits of internal control over financial reporting, and attestations on management's assessment of internal control over financial reporting (collectively, *audit* or *audits*).

The advisory does not apply to—

1. nonaudit services that may be performed by financial institutions' external auditors,
2. audits of financial institutions' 401(k) plans, pension plans, and other similar audits,
3. services performed by accountants who are not engaged to perform financial institutions' audits (e.g., outsourced internal audits or loan reviews), and
4. other service providers (e.g., software consultants or legal advisers).

While the agencies have observed several types of limitation-of-liability provisions in external audit engagement letters, this advisory applies to any agreement that a financial institution enters into with its external auditor that limits the external auditor's liability with respect to audits in an unsafe and unsound manner.

2060.1.4.2 External Audits and Their Engagement Letters

A properly conducted audit provides an independent and objective view of the reliability of a financial institution's financial statements. The external auditor's objective in an audit is to form an opinion on the financial statements taken as a whole. When planning and performing the audit, the external auditor considers the financial institution's internal control over financial reporting. Generally, the external auditor communicates any identified deficiencies in internal control to management, which enables management to take appropriate corrective action. In addition, certain financial institutions are required to file audited financial statements and internal control audit or attestation reports with one or more of the agencies. The agencies encourage financial institutions not subject to mandatory audit requirements to voluntarily obtain audits of their financial statements. The FFIEC's September 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations[4] notes, ''[a]n institution's internal and external audit programs are critical to its safety and soundness.'' The policy also states that an effective external auditing program ''can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the FDIC.''

Typically, a written engagement letter is used to establish an understanding between the external auditor and the financial institution regarding the services to be performed in connection with the financial institution's audit. The engagement letter commonly describes the objective of the audit, the reports to be prepared, the responsibilities of management and the external auditor, and other significant arrangements (for example, fees and billing). Boards of directors, audit committees, and management are encouraged to closely review all of the provisions in the audit engagement letter before agreeing to sign. As with all agreements that affect a financial institution's legal rights, the financial institution's legal counsel should carefully review audit engagement letters to help ensure that those charged with engaging the external auditor make a fully informed decision.

The advisory describes the types of objectionable limitation-of-liability provisions and pro-

4. See 64 Fed. Reg. 52,319 (September 28, 1999).

vides examples.[5] Financial institutions' boards of directors, audit committees, and management should also be aware that certain insurance policies (such as error and omission policies and directors' and officers' liability policies) might not cover losses arising from claims.

2060.1.4.3 Limitation-of-Liability Provisions

The provisions of an external audit engagement letter that the agencies deem to be unsafe and unsound can be generally categorized as follows: a provision within an agreement between a client financial institution and its external auditor that effectively—

1. indemnifies the external auditor against claims made by third parties;
2. holds harmless or releases the external auditor from liability for claims or potential claims that might be asserted by the client financial institution, other than claims for punitive damages; or
3. limits the remedies available to the client financial institution, other than punitive damages.

Collectively, these categories of provisions are referred to in this advisory as *limitation-of-liability provisions.*

Provisions that waive the right of financial institutions to seek punitive damages from their external auditor are not treated as unsafe and unsound under the advisory. Nevertheless, agreements by clients to indemnify their auditors against any third-party damage awards, including punitive damages, are deemed unsafe and unsound under the advisory. To enhance transparency and market discipline, public financial institutions that agree to waive claims for punitive damages against their external auditors may want to disclose annually the nature of these arrangements in their proxy statements or other public reports.

Many financial institutions are required to have their financial statements audited, while others voluntarily choose to undergo such audits. For example, federally insured banks with $500 million or more in total assets are required to have annual independent audits.[6] Furthermore, financial institutions that are public companies[7] must have annual independent audits. Certain savings associations (for example, those with a CAMELS rating of 3, 4, or 5) and savings and loan holding companies are also required by OTS's regulations to have annual independent audits.[8] The agencies rely on the results of audits as part of their assessment of a financial institution's safety and soundness.

For audits to be effective, the external auditors must be independent in both fact and appearance, and they must perform all necessary procedures to comply with auditing and attestation standards established by either the AICPA or, if applicable, the PCAOB. When financial institutions execute agreements that limit the external auditors' liability, the external auditors' objectivity, impartiality, and performance may be weakened or compromised, and the usefulness of the audits for safety-and-soundness purposes may be diminished.

By their very nature, limitation-of-liability provisions can remove or greatly weaken external auditors' objective and unbiased consideration of problems encountered in audit engagements and may diminish auditors' adherence to the standards of objectivity and impartiality required in the performance of audits. The existence of such provisions in external audit engagement letters may lead to the use of less extensive or less thorough procedures than would otherwise be followed, thereby reducing the reliability of audits. Accordingly, financial institutions should not enter into external audit arrangements that include unsafe and unsound limitation-of-liability provisions identified in the advisory, regardless of (1) the size of the financial institution, (2) whether the financial institution is public or not, or (3) whether the external audit is required or voluntary.

5. In the majority of external audit engagement letters reviewed, the agencies did not observe provisions that limited an external auditor's liability. However, for those reviewed external audit engagement letters that did have external auditor limited-liability provisions, the agencies noted a significant increase in the types and frequency of the provisions. The provisions took many forms, which made it impractical for the agencies to provide an all-inclusive list. Examples of auditor limitation-of-liability provisions are illustrated in the advisory's appendix A. See section 2060.1.4.7.

6. For banks and savings associations, see section 36 of the FDI Act (12 U.S.C. 1831m) and part 363 of the FDIC's regulations (12 C.F.R. 363).

7. Public companies are companies subject to the reporting requirements of the Securities Exchange Act of 1934.

8. See OTS regulation at 12 C.F.R. 563.4.

2060.1.4.4 Auditor Independence

Currently, auditor-independence standard-setters include the SEC, PCAOB, and AICPA. Depending on the audit client, an external auditor is subject to the independence standards issued by one or more of these standard-setters. For all nonpublic financial institutions that are not required to have annual independent audits, the FDIC's rules, pursuant to part 363 (or section 562.4 of the OTS's regulations) require only that an external auditor meet the AICPA independence standards. The rules do not require the financial institution's external auditor to comply with the independence standards of the SEC and the PCAOB.

In contrast, for financial institutions subject to the audit requirements in part 363 of the FDIC's regulations (or in section 562.4 of the OTS regulations), the external auditor should be in compliance with the AICPA's Code of Professional Conduct and meet the independence requirements and interpretations of the SEC and its staff.[9] In this regard, in a December 13, 2004, frequently asked question (FAQ) on the application of the SEC's auditor-independence rules, the SEC staff reiterated its long-standing position that when an accountant and his or her client enter into an agreement that seeks to provide the accountant immunity from liability for his or her own negligent acts, the accountant is not independent. The SEC's FAQ also stated that including in engagement letters a clause that would release, indemnify, or hold the auditor harmless from any liability and costs resulting from knowing misrepresentations by management would impair the auditor's independence. The FAQ is consistent with the SEC's Codification of Financial Reporting Policies, section 602.02.f.i, "Indemnification by Client." (See section 2060.1.4.8.)

On the basis of the SEC guidance and the agencies' existing regulations, certain limits on auditors' liability are already inappropriate in audit engagement letters entered into by—

1. public financial institutions that file reports with the SEC or with the agencies,
2. financial institutions subject to part 363,[10] and
3. certain other financial institutions that are required to have annual independent audits.

In addition, certain of these limits on auditors' liability may violate the AICPA independence standards. Notwithstanding the potential applicability of auditor-independence standards, the limitation-of-liability provisions discussed in the advisory present safety-and-soundness concerns for all financial institution audits.

2060.1.4.5 Alternative Dispute-Resolution Agreements and Jury-Trial Waivers

The agencies observed that a review of the engagement letters of some financial institutions revealed that they had agreed to submit disputes over external audit services to mandatory and binding alternative dispute resolution, binding arbitration, or other binding nonjudicial dispute-resolution processes (collectively, *mandatory ADR*) or to waive the right to a jury trial. By agreeing in advance to submit disputes to mandatory ADR, financial institutions may waive the right to full discovery, limit appellate review, or limit or waive other rights and protections available in ordinary litigation proceedings.

Mandatory ADR procedures and jury-trial waivers may be efficient and cost-effective tools for resolving disputes in some cases. Accordingly, the agencies believe that mandatory ADR or waiver of jury-trial provisions in external audit engagement letters do not present safety-and-soundness concerns, provided that the engagement letters do not also incorporate limitation-of-liability provisions. Institutions are encouraged to carefully review mandatory ADR and jury-trial provisions in engagement letters, as well as review any agreements regarding rules of procedure, and to fully comprehend the ramifications of any agreement to waive any available remedies. Financial institutions should ensure that any mandatory ADR provisions in audit engagement letters are commercially reasonable and—

1. apply equally to all parties,
2. provide a fair process (for example, neutral decision makers and appropriate hearing procedures), and
3. are not imposed in a coercive manner.

9. See part 363 of the FDIC's regulation (12 C.F.R. 363), *Appendix A—Guidelines and Interpretations, Guideline 14, "Role of the Independent Public Accountant-Independence."*
10. See also the OTS's regulation (12 C.F.R. 562.4).

2060.1.4.6 The Advisory's Conclusion

Financial institutions' boards of directors, audit committees, and management should not enter into any agreement that incorporates limitation-of-liability provisions with respect to audits. In addition, financial institutions should document their business rationale for agreeing to any other provisions that limit their legal rights.

The inclusion of limitation-of-liability provisions in external audit engagement letters and other agreements that are inconsistent with the advisory will generally be considered an unsafe and unsound practice. Examiners will consider the policies, processes, and personnel surrounding a financial institution's external auditing program in determining whether (1) the engagement letter covering external auditing activities raises any safety-and-soundness concerns and (2) the external auditor maintains appropriate independence regarding relationships with the financial institution under relevant professional standards. The agencies may take appropriate supervisory action if unsafe and unsound limitation-of-liability provisions are included in external audit engagement letters or other agreements related to audits that are executed (accepted or agreed to by the financial institution).

2060.1.4.7 Examples of Unsafe and Unsound Limitation-of-Liability Provisions

The following information was contained in appendix A of the February 9, 2006, interagency advisory.

Presented below are some of the types of limitation-of-liability provisions (with an illustrative example of each type) that the agencies observed in financial institutions' external audit engagement letters. The inclusion in external audit engagement letters or agreements related to audits of any of the illustrative provisions (which do not represent an all-inclusive list) or any other language that would produce similar effects is considered an unsafe and unsound practice.

1. "Release from Liability for Auditor Negligence" Provision

In this type of provision, the financial institution agrees not to hold the audit firm liable for *any* damages, *except* to the extent determined to have resulted from willful misconduct or fraudulent behavior by the audit firm.

Example: In no event shall [the audit firm] be liable to the financial institution, whether a claim be in tort, contract or otherwise, for any consequential, indirect, lost profit, or similar damages relating to [the audit firm's] services provided under this engagement letter, except to the extent finally determined to have resulted from the willful misconduct or fraudulent behavior of [the audit firm] relating to such services.

2. "No Damages" Provision

In this type of provision, the financial institution agrees that in no event will the external audit firm's liability include responsibility for any compensatory (incidental or consequential) damages claimed by the financial institution.

Example: In no event will [the audit firm's] liability under the terms of this agreement include responsibility for any claimed incidental or consequential damages.

3. "Limitation of Period to File Claim" Provision

In this type of provision, the financial institution agrees that *no* claim will be asserted after a fixed period of time that is shorter than the applicable statute of limitations, effectively agreeing to limit the financial institution's rights in filing a claim.

Example: It is agreed by the financial institution and [the audit firm] or any successors in interest that no claim arising out of services rendered pursuant to this agreement by, or on behalf of, the financial institution shall be asserted more than two years after the date of the last audit report issued by [the audit firm].

4. "Losses Occurring During Periods Audited" Provision

In this type of provision, the financial institution agrees that the external audit firm's liability will be limited to any losses occurring during periods covered by the external audit, and will not include any losses occurring in later periods for which the external audit firm is not engaged. This provision may not only preclude the collection of consequential damages for harm in later years, but could preclude any recovery at all. It appears that no claim of liability could be brought against the external audit firm until the external audit report is actually delivered. Under such a clause, any claim for liability thereafter might be precluded because the losses did not occur during the period covered by the external audit. In other words, it might limit the external audit firm's liability to a period before there could be any liability. Read more broadly, the external audit firm might be liable for losses that arise in subsequent years only if the firm continues to be engaged to audit the client's financial statements in those years.

Example: In the event the financial institution is dissatisfied with [the audit firm's] services, it is understood that [the audit firm's] liability, if any, arising from this engagement will be limited to any losses occurring during the periods covered by [the audit firm's] audit, and shall not include any losses occurring in later periods for which is not engaged as auditors.

5. *"No Assignment or Transfer" Provision*

In this type of provision, the financial institution agrees that it will not assign or transfer any claim against the external audit firm to another party. This provision could limit the ability of another party to pursue a claim against the external auditor in a sale or merger of the financial institution, in a sale of certain assets or a line of business of the financial institution, or in a supervisory merger or receivership of the financial institution. This provision may also prevent the financial institution from subrogating a claim against its external auditor to the financial institution's insurer under its directors' and officers' liability or other insurance coverage.

Example: The financial institution agrees that it will not, directly or indirectly, agree to assign or transfer any claim against [the audit firm] arising out of this engagement to anyone.

6. *"Knowing Misrepresentations by Management" Provision*

In this type of provision, the financial institution releases and indemnifies the external audit firm from any claims, liabilities, and costs attributable to any knowing misrepresentation by management.

Example: Because of the importance of oral and written management representations to an effective audit, the financial institution releases and indemnifies [the audit firm] and its personnel from any and all claims, liabilities, costs, and expenses attributable to any knowing misrepresentation by management.

7. *"Indemnification for Management Negligence" Provision*

In this type of provision, the financial institution agrees to protect the external auditor from third-party claims arising from the external audit firm's failure to discover negligent conduct by management. It would also reinforce the defense of contributory negligence in cases in which the financial institution brings an action against its external auditor. In either case, the contractual defense would insulate the external audit firm from claims for damages even if the reason the external auditor failed to discover the negligent conduct was a failure to conduct the external audit in accordance with generally accepted auditing standards or other applicable professional standards.

Example: The financial institution shall indemnify, hold harmless, and defend and its authorized agents, partners, and employees from and against any and all claims, damages, demands, actions, costs, and charges arising out of, or by reason of, the financial institution's negligent acts or failure to act hereunder.

8. *"Damages Not to Exceed Fees Paid" Provision*

In this type of provision, the financial institution agrees to limit the external auditor's liability to the amount of audit fees the financial institution paid the external auditor, regardless of the extent of damages. This may result in a substantial unrecoverable loss or cost to the financial institution.

Example: [The audit firm] shall not be liable for any claim for damages arising out of or in connection with any services provided herein to the financial institution in an amount greater than the amount of fees actually paid to [the audit firm] with respect to the services directly relating to and forming the basis of such claim.[11]

2060.1.4.8 Frequently Asked Questions on the Application of the SEC's Auditor-Independence Rules

The following information is contained in appendix B of the February 9, 2006, interagency advisory. The information is derived from the SEC's Office of Chief Accountant's Codification of Financial Reporting Policies.

Question[12]

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the commission under the Securities Act or the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act, as amended, or at ′common law,' other than for their willful misstatements or omissions."

Answer

When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. *Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation.*

Question

Has there been any change in the commission's long-standing view (Financial Reporting Policies—Section 600—602.02.f.i., "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?

Answer

No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity that seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, *the accountant is not independent.* Further, including in engagement letters a clause that a registrant would release, indemnify, or hold harmless from any liability and costs resulting from *knowing misrepresentations by management would also impair the firm's independence.*

2060.1.3 INSPECTION OBJECTIVES

1. To review the operations of the bank holding company to determine if an audit program exits.
2. To determine the independence and competence of those who administer and provide the internal and external audit function.

11. The agencies also observed a similar provision that limited damages to a predetermined amount not related to fees paid.
12. The subtitles in this section have been revised for this manual.

3. To determine the adequacy of the scope and frequency of the audit program.
4. To determine with reasonable assurance that the bank holding company has adequate internal audit and external audit functions that ensure efficient and effective operations, including the safeguarding of assets, reliable financial reporting, and compliance with applicable laws and regulations.
5. To ascertain if the bank holding company's internal audit function monitors, reviews, and ensures the continued existence and maintenance of sound and adequate internal controls over the bank holding company's management process—the control environment, risk assessment, control activities, information and communication, and monitoring activities.
6. To review and evaluate internal audit outsourcing arrangements and the actions of the outsourcing vendor under the standards established by the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.
7. To consider the policies, processes, and personnel surrounding the bank holding company's external auditing program and to determine the existence of any unsafe and unsound practices or conditions, including whether—
   a. any engagement letter or other agreement related to external audit activities (1) provides any assurances of indemnification to the bank's external auditors that relieves them of liability for their own negligent acts (including any losses, claims, damages, or other liabilities) or (2) raises any other safety-and-soundness concerns; and
   b. the external auditors have not maintained appropriate independence in their relationships with the bank holding company, in accordance with relevant professional standards.
8. To determine, based on the criteria above, if the work performed by internal and external auditors is reliable.

2060.1.6 INSPECTION PROCEDURES

The primary thrust of the inspection should be directed toward the audit activities that relate to the parent company and all subsidiaries. An assessment of the audit function as it pertains to the bank (or banks) is primarily the responsibility of the regulatory agency that examines that particular bank. The examiner should review the latest bank examination reports to note comments and deficiencies cited concerning internal controls and the audit function. In addition to providing an input into the overall assessment of the audit function, review of the bank examination reports may provide a basis for determining areas of investigation during the inspection. Further, if matters cited in the latest bank examination report are deemed to be significant and indications are that corrective action has not been taken, the examiner should mention the facts to senior management of the bank holding company and note the details in the inspection report.

To judge the adequacy of the audit program, including its scope and frequency, the following procedures, with equal emphasis being placed on the parent, bank, and nonbank subsidiaries, are recommended as minimum guidelines for the inspection.

1. Review the parent company and nonbank operations and the audit comments in the bank examination reports to ascertain the adequacy of the existing audit program or the need for developing such a program, if the organization currently lacks one.
2. Review the scope of the audit function to ensure that procedures are in place to cover adequately those areas that may be susceptible to exposure. When reviewing the audit scope, determine whether the auditor was able to perform all the procedures necessary to complete the audit. If not—
   a. establish whether the scope limitations were imposed by the directorship or management and
   b. determine whether the auditor established and documented the reasons why the scope limitations were imposed.
      (1) Was the auditor able to quantify the effects of the scope limitation on the financial statements and the audit results, and, if not pervasive, was a qualified opinion or disclaimer of opinion issued?
      (2) Did the auditor evaluate all possible effects on his ability to express an opinion on the financial statements?
      (3) Were there any external circumstances that imposed limitations on the audit's scope?
      (4) Were alternative procedures used to accomplish the same audit objectives? If so, did the use of the alternative procedures justify issuance of an unqualified opinion?

3. Review the audit schedule to determine that the audits are satisfactorily spaced and that all functions are audited with adequate frequency.
4. Review audit workpapers and reports on a test-check basis for adequacy of content, satisfactory maintenance, and conformance to audit guidelines outlined by the board of directors.
5. Determine the qualifications and background of the auditor and others participating in the audit function.
6. To establish that the auditor has a direct communication line to the board of directors and freedom of access to all records for audit purposes, review audit reports and minutes of meetings held by directors or a committee thereof.
7. Determine the entity responsible for maintaining the audit function. If a bank provides audit services to affiliates, indicate the manner in which the bank is reimbursed for the cost of such services.
8. Determine whether audit reports are submitted on a timely basis to—
   a. the directors and senior management and
   b. management in the area being audited.
9. Review responses to exceptions and recommendations noted in audit reports.
10. Check on the relationship between the internal and any external auditors to determine whether their activities are coordinated in a manner that effects comprehensive coverage of the organization and at the same time avoids duplication of effort.
11. Review the letter addressed to management by the external auditor and determine that steps have been taken to correct any deficiencies noted. If no deficiencies were noted in the letter, inquire as to whether such comments were communicated to management by any other means.
12. Ascertain that the audit program is annually reviewed and approved by the directors.
13. If the BHC has engaged any external audit firms to conduct audits of its financial statements (including their certification), audits of internal control over financial reporting, attestations on management's assessment of internal control, appraisals of the BHC's audit function, or any internal audit or audit function or operational review, the examiner should:
   a. Review the engagement letters (including past or pending engagement letters) and any agreements between the board of directors (and the audit committee) and the external auditor, noting any qualifications that are contained therein.
   b. Review any correspondence exchanged between the BHC and the external auditor, including any letters requesting opinions from external auditors. Determine if BHC management influenced any of the opinions.
   c. Ascertain if any of the engagement letters restricted the scope of the audit in any way, including whether the letters limited the degree of reliance to be placed on the work of the internal audit staff.
14. Determine if the audit engagement letters or other agreements include possible unsafe and unsound provisions or practices that—
   a. indemnify the external auditor against all claims made by third parties;
   b. hold harmless, release, or indemnify the external auditor from liability for claims or potential claims that the BHC may assert, thus providing relief from liability for the auditors' own negligent acts, including any losses, claims, damages, or other liabilities, (other than claims for punitive damages); or
   c. limit the remedies available to the BHC (other than punitive damages).
15. Find out whether the BHC's board of directors, audit committee, and senior management closely review all of the provisions of audit engagement letters or other agreements for providing external auditing services for the bank before agreeing to sign, thus indicating the BHC's approval and financial commitment.
16. Verify that the BHC has documented its business rationale for any engagement letter or other agreement provisions with external audit firms that limit or impair the BHC's legal rights.
17. If new external auditors have been engaged, ascertain the reasons for such change.
18. Determine if the parent company or nonbank subsidiaries have reported any defalcations. If so, determine if adequate controls have been initiated to lessen any further risk and exposure.
19. Determine if the BHC's external auditors received copies of the subsidiary FDIC-insured institution's examination and other designated supervisory reports and correspondence required by section 36(h)(1) of the FDI Act.

20. Determine the degree of independence of the external audit firm by reviewing any financial ties between the BHC, audit firm, and any of its partners or employees. Also review any other relationships or potential conflicts of interest that may exist.[13]

The independence of the internal auditor should be evaluated by ascertaining whether the following conditions exist: (1) reports are distributed directly to the board or a committee thereof or, less desirably, to an officer not connected with the area being reviewed; (2) there are no relationships within the organization that are incompatible with the internal audit function; and (3) severe restrictions are not placed on the program or its scheduling by management. In order to maintain the degree of objectivity essential to the audit function, the examiner should establish that the internal auditor does not install procedures, originate and approve entries, or otherwise engage in any activity that would be subject to audit review and appraisal.

The examiner should consider meeting with the audit committee and the auditor and, subsequently, with senior bank holding company management to communicate conclusions concerning the adequacy of the scope and frequency of the audit program. During the discussions, the examiner should concentrate on detailing criticisms or deficiencies noted. The auditor and senior bank holding com-pany management should be made fully cognizant of the examiner's analyses and the comments concerning the audit function that will appear on the relevant pages in the inspection report.

13. The Securities and Exchange Commission (SEC) has also released guidance relating to the independence of auditors for public institutions. According to SEC Rule 101, the independence of an auditor would be impaired if there are financial, employment, or business relationships between auditors and audit clients, or if there are relationships between auditors and audit clients in which the auditors provide certain nonaudit services to their audit clients. Much of the language found in the SEC's independence rules is incorporated in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing. (See section 2060.05.)

2060.1.7 (reserved for future use)

2060.1.8 OVERVIEW: INTERAGENCY ADVISORY ON EXTERNAL AUDITS OF INTERNATIONALLY ACTIVE U.S. FINANCIAL INSTITUTIONS

The federal banking agencies (the agencies)[14] issued this interagency advisory to communicate the agencies' support for the principles and expectations set forth in parts 1 and 2, respectively, of the Basel Committee on Banking Supervision's (the BCBS or the Committee) March 2014 guidance on "External audits of banks" (hereafter, referred to as "the BCBS external audit guidance").[15]

In supporting these principles and expectations, the agencies acknowledge that the existing standards and practices in the United States are broadly consistent with the BCBS external audit guidance. However, because of the legal and regulatory framework in the United States, certain differences exist between the standards and practices followed in the United States and the principles and expectations in the BCBS external audit guidance. These differences are addressed in this advisory, which also describes the agencies' supervisory expectations for U.S. financial institutions within the scope of this advisory for incorporating the principles and expectations in the BCBS external audit guidance into their practices. This advisory also outlines examiner responsibilities related to these supervisory expectations.

The BCBS external audit guidance is intended for "internationally active banks" and is relevant for the management, audit committees, external auditors, and prudential supervisors of such financial institutions. The agencies define "internationally active banks" in the advisory. (Refer to SR-16-2 and its attachment.)

14. The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

15. See www.bis.org/publ/bcbs280.pdf.

2060.1.8.1 Appendix A—Interagency Advisory on External Audits of Internationally Active U.S. Financial Institutions

Scope

The BCBS external audit guidance is intended for "internationally active banks" and is relevant for the management, audit committees, external auditors, and prudential supervisors of such financial institutions. For purposes of this advisory, the agencies are defining "internationally active banks" as:

- Insured depository institutions that meet either of the following two criteria: (1) consolidated total assets of $250 billion or more; or (2) consolidated total on-balance sheet foreign exposure of $10 billion or more (referred to as "core banks"); and
- U.S. depository institution holding companies that meet any of the following three criteria: (1) consolidated total assets (excluding assets held by an insurance underwriting subsidiary) of $250 billion or more; (2) consolidated total on-balance sheet foreign exposure of $10 billion or more; or (3) have a subsidiary depository institution that is a core bank.

In the United States, core banks are subject to 12 CFR 363, the Federal Deposit Insurance Corporation's (FDIC) regulation on Annual Independent Audits and Reporting Requirements.[16] Core banks typically comply with 12 CFR 363 requirements at a holding company level. In addition, these holding companies generally are public companies that are required to file annual, quarterly, and other periodic reports with the U.S. Securities and Exchange Commission (SEC). The Public Company Accounting Oversight Board (PCAOB) regulates the external auditors of these public companies.

Background

In March 2014, the Committee published the BCBS external audit guidance to improve the external audit quality of banks and enhance the effectiveness of prudential supervision, which contributes to financial stability. The BCBS external audit guidance elaborates on Core Principle 27, *Financial Reporting and External Audit,* of the Committee's Core Principles for Effective Banking Supervision[17] by providing guidance related to bank audit committees' responsibilities in overseeing the external audit function. This guidance also discusses prudential supervisors' relationships with external auditors of banks and audit oversight bodies. Additionally, the BCBS external audit guidance includes information relevant to external audits of financial statements that the Committee believes will enhance the quality of these external audits.

The BCBS external audit guidance has two parts:

- Part 1 provides guidance (principles) on the roles and responsibilities of audit committees relevant to external audits and the engagement of bank supervisors with external auditors and external auditors' regulators.
- Part 2 of the document (expectations) emphasizes the proper application of existing internationally accepted auditing standards. The BCBS external audit guidance also provides recommendations for procedures that external auditors could perform in the execution of bank audits to enhance audit quality.[18]

Supervisory Expectations Regarding the Differences Between U.S. Standards and Practices and the BCBS External Audit Guidance

The BCBS external audit guidance builds upon internationally accepted auditing standards and sets expectations for institutions and their external auditors. In the United States, financial institutions within the scope of this advisory are directly or indirectly subject to the audit requirements of 12 CFR 363[19] and supervisory guid-

16. 12 CFR 363 applies to any insured depository institution with respect to any fiscal year in which its consolidated total assets as of the beginning of such fiscal year are $500 million or more.

17. The Committee's Core Principles are available at www.bis.org/publ/bcbs230.pdf. In particular, Core Principle 27 states, "The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function."

18. The BCBS external audit guidance acknowledges that the Committee does not have the authority to set professional standards for external auditors.

19. 12 CFR 363.3(f) requires external auditors to comply

ance related to audits of financial institutions.[20] In order for a core bank to comply with the audited financial statements requirement of 12 CFR 363 at a public holding company level, the audit must be performed in accordance with PCAOB standards. The 12 CFR 363 audit requirements, supervisory guidance, and PCAOB standards, collectively, are generally consistent with the BCBS external audit guidance, except for the differences noted below. This advisory discusses the agencies' supervisory expectations regarding these differences with reference to the corresponding principles from part 1 and expectations from part 2 of the BCBS external audit guidance.

Part 1, Principle 2: The audit committee should monitor and assess the independence of the external auditor.

Paragraph 49 of the BCBS external audit guidance indicates that an institution's audit committee should have a policy in place that stipulates the criteria for "tendering," i.e., putting its external audit contract out for bid. This paragraph further states that the policy also should call for the audit committee to periodically consider whether to put the external audit contract out for bid. Consistent with 12 CFR 363, the banking agencies encourage audit committees to establish policies and procedures addressing the retention and remuneration of the external auditor (independent public accountant).[21] In addition, the external auditors of insured depository institutions subject to 12 CFR 363 must comply with the SEC's rules regarding audit partner rotation. Audit committees are encouraged to consider whether their policies should explicitly address the criteria for tendering the audit contract and whether the contract should periodically be put out for bid.

Part 1, Principle 6: The supervisor and the external auditor should have an effective relationship that includes appropriate communication channels for the exchange of information relevant to carrying out their respective statutory responsibilities.

and

Part 1, Principle 7: The supervisor should require the external auditor to report to it directly on matters arising from an audit that are likely to be of material significance to the functions of the supervisor.

Paragraphs 95 and 96 of the BCBS external audit guidance indicate that the auditor may share information about the external audit of an institution that may be of interest to the depository institution's supervisor (e.g., significant risks of material misstatements, significant or unusual transactions, evidence of management bias, significant deficiencies or material weaknesses in internal control over financial reporting, and actual or suspected breaches of regulations or laws[22]), either (1) directly with the supervisor when a safe harbor exists or (2) indirectly through the institution to the supervisor when a legal safe harbor does not exist. Paragraph 99 of the BCBS external audit guidance provides that the external auditor should communicate matters arising from the audit that may be of material significance to the supervisor when required by the legal or regulatory framework or by a formal agreement or protocol. According to the BCBS external audit guidance, "[a] matter or group of matters is normally of material significance ... when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator."[23]

There is no generally applicable legal or regulatory requirement in the United States for external auditors of banks and holding companies to report directly to the institution's primary federal (and, if applicable, state) supervisor matters arising from the audit that may be of material significance, nor is there a legal safe harbor to do so. Insured depository institutions subject to 12 CFR 363 are required to file with appropriate federal and state supervisors copies of reports and other written communications issued by the external auditor to the institution in connection with the external audit services provided to the institution. Consistent with interagency policy

with the independence standards and interpretations of the American Institute of Certified Public Accountants, the SEC, and the PCAOB.

20. For example, *Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners* (July 23, 1992).

21. 12 CFR 363.5(a) states, "The duties of the audit committee shall include the appointment, compensation, and oversight of the independent public accountant who performs services required under this part, and reviewing with management and the independent public accountant the basis for the reports issued under this part."

22. See also paragraphs 90-94 of the BCBS external audit guidance.

23. See footnote 9 in the BCBS external audit guidance.

statements[24] and practices, the agencies continue to encourage open and candid communication between an institution's external auditor and the institution's supervisors.

Part 2, Expectation 5: The external auditor of a bank should identify and assess the risks of material misstatement in the bank's financial statements, taking into consideration the complexities of the bank's activities and the effectiveness of its internal control environment.

and

Part 2, Expectation 6: The external auditor of a bank should respond appropriately to the significant risks of material misstatement in the bank's financial statements.

Paragraphs 157 and 168 of the BCBS external audit guidance set forth the Committee's expectations for external auditors to (1) consider regulatory ratios in the determination of materiality for the audit, and (2) evaluate any identified audit differences, errors, and adjustments and their effect on regulatory capital or regulatory capital ratios. PCAOB standards[25] and SEC Staff Accounting Bulletin Topic 1.M, Materiality, indicate external auditors should consider qualitative factors (which include regulatory capital, ratios, and disclosures) in determining materiality and when evaluating the effect of audit differences, errors, and adjustments. Therefore, the agencies expect institutions' audit committees will ensure that their external auditors consider regulatory capital ratios in planning and performing the audit. In this regard, audit committees are encouraged to inquire as to how the external auditors factored these ratios into their materiality assessments.

Additionally, paragraph 166 of the BCBS external audit guidance recommends that the external auditor provide written feedback about the audit engagement team's relations with the institution's internal audit function, including its observations on the adequacy of the work of internal audit, to those charged with governance of the bank. PCAOB Auditing Standard No. 16, *Communications with Audit Committees,* requires the external auditor, as part of communicating the overall audit strategy, to explain the extent to which the auditor plans to use the work of internal audit in an audit of the financial statements or an audit of internal control over financial reporting. However, PCAOB standards do not require the external auditor to provide written feedback about the audit engagement team's relations with the institution's internal audit function, including its observations on the adequacy of the work of internal audit. The agencies encourage audit committees to consider requesting their external auditor to provide written feedback about the audit engagement team's relations with internal audit, including its observations on the adequacy of the work of internal audit, as it relates to the audit of the financial statements or the audit of internal control over financial reporting.

Furthermore, consistent with the March 2003 *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing,* an institution's audit committee should consider whether the institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA) *International Professional Practices Framework* (previously known as the *Standards for the Professional Practice of Internal Auditing).* Audit committees may look to the IIA's Framework for guidance for both internal and external assessments of the internal audit function.

Examiner Responsibilities

Examiners should evaluate any actions taken by institutions within the scope of this advisory and their audit committees to ensure such actions are consistent with the objectives of this advisory and the BCBS external audit guidance. Where there are differences between the BCBS external audit guidance and U.S. standards, examiners should encourage institutions' audit committees to follow the practices identified in this advisory.

Conclusion

External auditors play an important role in contributing to financial stability when they deliver quality audits, which foster market confidence in institutions' financial statements. Quality audits are also a valuable complement to the supervisory process. The agencies support the principles and expectations set forth in the BCBS external audit guidance because

24. See footnote 6 of this advisory.
25. See PCAOB Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit, paragraph 6, and PCAOB Auditing Standard No. 14, Evaluating Audit Results, appendix B, paragraph B2.

enhanced audit quality is an important factor in ensuring the safety and soundness of U.S. institutions. Institutions and their external auditors are expected to comply with existing laws, regulations, and professional standards, as applicable, including those referenced in this advisory.

An assessment of management's strategic plans and its success in meeting previously established budgetary goals is one of the factors considered in evaluating a BHC's management, operations, financial condition, and prospects.[1] Through review of the budget figures, insight can be gained concerning an organization's future plans and other matters such as capital adequacy, liquidity, sources and applications of funds, level and quality of earnings, and performance of management.

The budget is a coordinated financial plan used to estimate and control all or a few of the activities of the various divisions or subsidiaries in a bank holding company. Based on an assessment of future economic developments and conditions, management formulates a plan of action and indicates anticipated changes in the balance-sheet accounts and profitability (predicated on implementation of the plan). The budget is a significant management tool in that it projects expected results and also serves as an important check on management decisions and performance by providing a basis for comparison and corrective action on a timely basis. The comparison of actual performance to budget allows management to give careful attention to various possible courses of action and to choose the course which should result in the greatest benefit. Budgeting is also useful in measuring the performance of individuals and the departments they manage. Further, the comparison of budget totals to actual changes in activities such as loans, investments, and deposits assists in decision making and can promote coordination and cooperation among affiliates. The variance indicated by the comparison process may be construed as a measure of management's performance and planning record and its relationship to the organization's goals and objectives. It should be noted that some significant variances may be caused by factors beyond management's control or factors that could not reasonably be anticipated.

1. The *stragetic planning process* focuses on intermediate and long-term strategic goals and is the vehicle used to determine the overall direction and focus of the organization. The *budgeting process* refers to the tactical decisions required to meet goals and objectives. The budget is a subset of the strategic plan. While smaller bank holding company organizations may not always have formal written budgets, all organizations should have a strategic planning process, which determines overall corporate direction, general resource allocation, and balance-sheet relationships with respect to capital needs, growth, asset mix, and risk.

While various individuals may be responsible for input to the budget process, the chief executive officer typically has the ultimate responsibility for preparation and implementation of the formal budget. The time period covered by a budget typically encompasses one year, although it often covers longer periods in the larger, more sophisticated bank holding companies. The longer the budget period, the greater are the prospects for increased variances from original budget figures. In some cases in which four- or five-year projections are made, bank holding companies may formulate several forecasts based on different sets of assumptions. In such instances, the examiner should work with the "most likely" situation that may evolve based on economic trends, history, and experience of the organization, but should also give serious consideration to the "worst-case" projections.

Many bank holding companies, particularly the smaller organizations, may not have formal written budgets or plans. In small shell companies, while it is not essential to have a formal budget, budgeting procedures should be encouraged where appropriate. Budgeting at the parent level could be appropriately limited to debt-servicing and dividend considerations.

2060.2.1 INSPECTION OBJECTIVES

1. To determine the extent of an organization's financial planning and budget program.
2. To indicate to management of organizations that are without formal planning procedures the advantages of adopting a budget.
3. To understand the institution's decision-making process as it relates to the budget.
4. To determine the causes of significant variances between the budget and actual performance.
5. To assess the reasonableness of projected figures, including controls over the data throughout the budgeting process.
6. To assess the impact of the budget on the present condition and future prospects of the bank holding company.
7. To determine whether the plan outlined in the budget is supported by the financial and managerial resources of the holding company.

2060.2.2 INSPECTION PROCEDURES

1. Familiarity with a bank holding company's financial condition and results of operations should begin before the start of the inspection with a review of the annual report to shareholders, financial reports submitted to the Federal Reserve System, and other financial documentation contained in the files. The more significant accounts, statistical data, and pertinent ratios should be compared on a period-to-period basis to highlight significant changes and discern trends.

2. The examiner also should become familiar with current and projected economic conditions, both nationally and locally, including general industry conditions.

3. Based on a review of the aforementioned data, the examiner should be in a position to substantiate the reasonableness of budgeted figures without a systematic examination of all of the transactions affecting the figures presented. Further, such an analysis provides a better understanding of the operation and highlights matters of interest and potential problem areas to be investigated during the inspection.

4. Throughout the review process, the examiner must maintain a sense of perspective to avoid spending excessive time on relatively immaterial amounts.

5. The examiner should meet with the officer responsible for the preparation of the budget to determine the scope of the organization's financial plans. The extent of senior management's and the board of directors' involvement in the strategic planning and budgeting process should also be ascertained in this preliminary meeting.

6. Workpapers which document or illustrate the rationale for the budget data should be reviewed and discussed with budget personnel, including the existence and extent of internal controls over the data.

7. The examiner should evaluate plans, projections, and forecasts in light of market-area characteristics and the present condition and history of the organization.

8. The examiner should determine whether the accounting principles of major importance have been applied consistently and, if not, the impact of the alternative accounting treatment on the budget totals.

9. The sources of input for the budget should be reviewed and the frequency and procedures for effecting revision should be ascertained.

10. When there are significant budget variances, the examiner should seek documented explanations. Review any such documentation to determine if management policy or factors beyond management control were responsible for the variances.

11. A final summary discussion should be held with management to discuss goals which the examiner believes may be unattainable and to communicate conclusions concerning the budget. Due consideration should be given to management's views, whether or not in concurrence with the examiner's conclusions. If management indicates future changes which could have a significant impact on the organization, the matter should be noted in the inspection report. Further, management's assessment of the effect of contemplated action on the operations and financial condition of the bank holding company should be noted.

12. For those bank holding companies that do not have formal written plans, the examiner should obtain from senior management information on their plans for matters such as growth and expansion, capital injections, debt retirement, and changes in sources of funding. Except for small, shell companies, the examiner should recommend adoption of a budget program and emphasize the need for strategic planning by indicating how management methods may be improved as a result of a logically conceived and properly operated budget. Budgets and planning are especially important in cases in which a bank holding company is losing its share of the market or in which inefficiencies are depressing profitability.

Adequate and accurate records and financial statements are an integral part of a sound bank holding company operation. Records should be maintained to allow preparation of financial statements in accordance with generally accepted accounting principles and to ensure proper accountability for all assets, liabilities, income, and expenses. Generally, an independently certified statement inspires greater confidence than a statement prepared internally. Moreover, an unqualified, independently certified statement may act as a check on management recordkeeping policies and procedures, and provide more assurance that transactions are being properly recorded and that books accurately reflect overall financial condition.

Management may exercise reasonable discretion in selecting and adopting the type of books and records it uses and in formulating accounting systems and bookkeeping procedures. From the examiner's viewpoint, the test of a bank holding company's records is one of adequacy, consistency, and accuracy. The financial statements of every bank holding company must accurately reflect financial condition and operating results. This principle is applicable whether a bank holding company is small and has a relatively simple bookkeeping system or whether it is a larger institution with a fully automated system. A recordkeeping system that is capable of generating a wide variety of pertinent internal data and other information facilitates problem solving and decision making and, thus, contributes to the efficiency of a bank holding company's operations. Further, such a system serves as a convenient tool to provide directors, stockholders, and other interested parties with information on conditions in a bank holding company.

2060.3.1 INSPECTION OBJECTIVES

1. To determine whether financial statements are prepared in accordance with generally accepted accounting principles and are sufficiently detailed to accurately portray the company's financial condition.
2. To determine that sufficient records are maintained to provide detail on material balance-sheet items, income-statement items, and various contingent liabilities and off-balance-sheet risks that permit the preparation of appropriate financial information.
3. To recommend corrective action when policies and procedures employed have resulted in inadequate or inaccurate records and financial statements.

2060.3.2 INSPECTION PROCEDURES

1. The examiner should review the sections relating to audit and records in the prior inspection report and the latest examination reports of the subsidiary banks to note any comments or deficiencies cited concerning records, including any MIS deficiencies. In addition to providing an input into the overall assessment of the quality of records, the review may provide a basis for determining areas of emphasis and follow-up during the inspection.
2. The examiner should discuss recommendations and criticisms contained in such reports with an appropriate officer to ascertain what changes, if any, have taken place.
3. The examiner should review the external auditing firm's management letter, giving particular attention to comments concerning recordkeeping. Determine if any corrective actions were recommended by the external auditors and the extent to which the cited items have been corrected.
4. In those situations when it appears that records are deficient or financial statements are inaccurate, a thorough investigation of applicable transactions may be required. The purpose of the investigation is to obtain information needed in outlining improved controls over MIS, accounting methods, and records so that the financial data presented are in accordance with generally accepted accounting principles. Thus, information is provided which will better serve bank holding company management. The investigation should not necessarily involve a review of every transaction, but should involve a check of a sufficient number of transactions to ensure the examiner that the records, as checked, reflect an accurate financial condition. The extent of the review will depend largely on the procedures and controls over MIS and the condition and adequacy of the books and underlying records. During the investigative process, the examiner should be careful to distinguish between documented facts and statements of intent or interpretations set forth by company representatives.

The directorate and management of bank holding companies have a responsibility to contribute to the health and growth of the organization they serve. To carry out this responsibility effectively, they must be kept fully informed of conditions throughout the organization and trends within the banking industry. Reporting is the process of developing and communicating information internally to directors and management and externally to shareholders and regulatory authorities. Management and the board of directors must recognize that as a company develops and grows, its environment, strategic goals, and information needs change. The guidelines and requirements for reports flowing to management and the board of directors should be established and allow for change, recognizing the fact that informational needs can vary, including those at different levels of the organization.

Informational needs will also be dictated by the particular type of management structure in place—centralized, decentralized, legal entity, or business line. The ultimate decision-making responsibility rests with the corporation's board of directors, and the responsibility for implementing their decisions rests with designated board committees, executive management, or other designated management committees or individuals. As such, examiners should make an assessment of the qualifications of the persons on the board of directors, executive management staff, and the board and executive management committees to ensure that they have the necessary knowledge, experience, and expertise to understand the information presented and to act on it constructively. The assessment should include a review of reporting lines to identify information flows and the various decision-making levels involved or needed.

All reports flowing to executive management, board committees, and the board of directors should be analyzed for clarity, consistency, timeliness, quality, and coverage of crucial areas of the organization. A review of board and committee minutes should reveal if participants had any questions or whether there were any uncertainties as to the meaning of the data presented.

Each bank holding company prepares various reports for submission to its management and directors; an effective internal reporting system facilitates their ability to analyze a situation and to make informed decisions. Although such reports may vary in content from company to company, emphasis is generally placed on the financial data generated. The important consideration is whether each company is providing sufficient data to keep the interested parties informed of the financial condition and performance of all the divisions or entities. The frequency of the reporting and the detail of information provided can be categorized as being on a need-to-know basis. The form of reports ranges from consultations and meetings to submission of printed material for study and review. The scope and size of the operations will have an effect on the frequency and detail of the information submitted. In the larger, more sophisticated companies, frequent meetings and consultations are held to discuss the performance of various entities, the impact of performance on the organization's goals and objectives, and policies and strategies to be followed. Written reports outlining important matters and summarizing various financial data are typically reviewed and discussed regularly.

The number and variety of reports depends on the size and sophistication of the bank holding company operation. For smaller bank holding companies, the extent of their reports may be limited to annual statements, as more frequent periodic reports may not be necessary under normal conditions. The larger holding companies normally prepare monthly comparative balance sheets and income statements covering similar periods for two consecutive years. Thus, any significant deviation from the prior year's data can be readily detected. Generally, reports detailing the extent of delinquent and nonaccrual loans are prepared monthly. Facts and figures pertaining to the adequacy of the loan-loss provision are presented periodically. Additional reports containing information on budgets, cash flow, liquidity, and capital adequacy are prepared to assist management in assessing the organization's overall financial condition and performance. Summaries of internal audit reports and reports of examinations of subsidiary banks are brought to management's attention. Data relative to other bank holding companies or banks in the same peer groups are assembled, when available, so that comparisons with similarly sized organizations are possible. All of the aforementioned information may be prepared for directors, although not necessarily in as much detail as that submitted to management. On occasion, key management personnel of the holding company attend directors' meetings to expand on the topics being discussed.

Reports to shareholders usually consist of quarterly and annual reports which detail the company's financial condition and results of operations. Additional information may include the chief executive officer's overall assessment of the company, future plans, and other financial and analytical data. The financial information is used for public disclosure and enables investors, depositors, and creditors to make informed judgments concerning the financial condition of the bank holding company. Bank holding companies whose securities have been registered pursuant to the Securities and Exchange Act of 1934 are required to prepare various reports containing specific financial information.

2060.4.1 INSPECTION OBJECTIVES

1. To review the organizational structure to determine the various levels of decision-making and reporting lines, including board and executive management committees.
2. To determine whether the bank holding company has written policies and procedures, and internal controls covering the types of reports required to be submitted to management and the directors.
3. To determine that the required reports are adequate to accurately reflect the financial condition and performance within the organization's divisions and units and whether the reporting systems and reports are adequate to monitor the risks therein.
4. To evaluate whether the reports and reporting systems are adequate to measure and reflect the company's financial position and performance in all areas, to measure the company's progress in meeting its financial and business goals, and to monitor inherent risks.
5. To determine that the contents of the reports are complete and submitted on a timely basis.
6. To recommend corrective action when reporting practices, policies, or procedures are deficient.
7. To evaluate management's procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by reporting systems, and to evaluate the system's ability to adapt to change caused by regulatory and accounting issues or other market conditions.

2060.4.2 INSPECTION PROCEDURES

1. Review the organizational structure to determine reporting lines and the various levels of decision making, risk assessment, and controls.
2. Ascertain whether any corporate policies address risk managment or internal reporting requirements and determine:
   a. the types of reports required to be submitted and
   b. the adequacy of such reporting requirements in light of a company's particular circumstances.

   Comment: In a holding company with a decentralized system of control over subsidiaries, the existence of written policies and procedures is important since each subsidiary operates as a relatively autonomous unit.
3. Obtain a listing of internal reports that are submitted to corporate executive management and the board of directors (including packages for the board of directors and executive committees).
4. Randomly sample, based on a material risk focus, the individual as well as the various types of management reports and determine whether they are adequately prepared in accordance with established policies and procedures and submitted to the appropriate individuals on a timely basis. Determine whether the management reports are sufficient to measure the company's progress in achieving its financial and business goals and forecasts.
5. Identify and document management procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by MIS. Also evaluate the ability of the information system to handle regulatory and accounting issues and to adapt to change.
6. At the conclusion of the review process, the examiner should discuss with management, as appropriate, topics such as—
   a. the lack of established policies and procedures and internal controls,
   b. inadequate reporting requirements, and
   c. noncompliance with reporting requirements and/or the untimely submission of reports.

2060.4.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Registration, reports, and examinations or inspections		225.5		
Reporting requirements emanating from the Securities Exchange Act of 1934	15 USC 78a et seq.			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2060.5.1 INTRODUCTION

In establishing an insurance program, a bank holding company should be aware of where it is exposed to loss, the extent to which insurance is available to cover potential losses and the cost of such insurance. These various factors should be weighed to determine how much risk the bank holding company will assume directly. In assessing the extent of risk an organization is willing to assume, it is important to analyze the impact of an uninsured loss not only on the entity where the loss occurs, but also on the affiliates and the parent. Once appropriate coverage has been acquired, procedures should be established for the periodic review of the program to assure the continuing adequacy of the coverage. Particularly for larger BHCs, these procedures should include at least an annual review of the program by the board of directors of the parent organization.

Insurance is a highly specialized field and no attempt is made here to discuss all the various types and forms of insurance coverage that are available to financial institutions. Examiners are not expected to be insurance experts; however, examiners should recognize that a financial organization's primary defenses against loss include adequate internal controls and procedures and that insurance is intended to complement, not replace, an effective system of internal controls. Thus, an overall appraisal of the control environment becomes a significant consideration in assessing the adequacy of the insurance program. To the extent controls are lacking, the need for additional coverage increases.

2060.5.2 BANKER'S BLANKET BOND

The most important and comprehensive insurance coverage available is the bankers' blanket bond which is usually extended to encompass all the entities in a bank holding company structure. Generally, the scope of the blanket bond contract is intended to cover risks of loss due to criminal acts, such as embezzlement, burglary, robbery, theft, larceny, forgery, etc., but in addition it provides indemnity for loss of property through damage, destruction, misplacement and mysterious, unexplainable disappearance. The most important item of protection under the bond, however, is the blanket fidelity coverage for officers and employees.

2060.5.3 TYPES OF BLANKET BONDS

While there are several similar forms of blanket bonds in use, those commonly found are the Financial Institutions Bond Standard Form No. 24, the Bankers Blanket Bond Standard Form No. 2, and Lloyd's Banks' and Trust Companies' Policy HAN Form (C). Under these blanket forms, every employee is usually covered for the total amount of the bond. Typically, new employees and new offices are automatically covered and no notice is required for an increase in the number of employees or in the number of offices established, unless such increases result from a merger or consolidation with another institution. The word "blanket," however, refers to the over-all amount that applies to the several specified risks covered under the bond and is not intended to mean "all risks" coverage. A most important feature of the bankers' blanket bond is the "discovery rider." The rider, which converts the blanket bond from a "loss sustained basis" to a "discovery basis," provides indemnity against any loss sustained by the insured entity at any time but discovered after the effective date of the bond and prior to the termination or cancellation of the bond, even though lower amounts of insurance and more restrictive coverage may have been carried when the loss was actually sustained.

2060.5.4 DETERMINING THE COVERAGE NEEDED

One of the most difficult insurance problems management faces is the determination of the amount of blanket bond coverage that should be maintained. An estimate of the maximum amount of money and securities that may be lost through burglary or robbery can be calculated with reasonable accuracy, but the potential loss resulting from dishonest acts of officers and employees is not easily measured. The Insurance and Protective Committee of the American Bankers Association has conducted several studies of the problems of determining adequate coverage and has concluded that total deposits represent the most appropriate item in bank financial statements upon which to base an estimate of a reasonable or suitable amount of blanket bond coverage.

In a bank holding company structure, the amount of blanket bond coverage is generally determined by the deposits of the largest bank and the amount of suggested coverage in the ABA's schedule. Such an amount is considered to be a minimum and other factors such as a rapidly expanding operation, excessive cash on hand, or inferior audit and control practices may suggest the need for larger coverage. Since coverages are generally extended to include the nonbank subsidiaries and such subsidiaries usually operate on a smaller scale than their affiliated banks, the question concerning the adequacy of the amount of the blanket bond coverage for a nonbank subsidiary is more easily addressed and is typically a function of the parent's and the bank's coverage.

2060.5.5 NOTIFICATION OF LOSS

When submitting a claim, most blanket bonds have provisions which require a report to be submitted within a specified period after a reportable item comes to the attention of management. Occasionally, items are not reported to the bonding company because of uncertainty as to whether the incident constitutes a reportable item. Failure to report in a timely manner could invalidate the claim and jeopardize existing coverages. Thus, it should be emphasized to management that any questionable items should be reported.

2060.5.6 DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance (“DOL Insurance”) insures the Directors and Officers against *personal* liability resulting from claims of alleged negligence, wrongful acts, errors and omissions, etc. This insurance is not included in the blanket bond or other standard fidelity coverage.

2060.5.7 INSPECTION OBJECTIVES

1. To determine the scope and extent of insurance coverages for the various entities in the organization.
2. To determine the adequacy of insurance coverage after giving due consideration to the overall control environment and factors such as the organization's claim experience and costs associated with various coverages.
3. To ascertain that a comprehensive review of the insurance program is conducted periodically by management and at least annually by the board of directors and entered into the minutes.
4. To determine the entity(ies) responsible for paying the premiums and the manner in which such payments are allocated among the affiliates that receive the coverage benefits.
5. To determine if procedures are in place to assure that claims are filed promptly.

2060.5.8 INSPECTION PROCEDURES

1. The prior year's inspection report should be reviewed for comments relative to controls and insurance. The examiner should note the types and extent of coverages, comments concerning the control environment and any deficiencies related to the administration of the insurance program and the coverages in force.
2. A similar review encompassing the latest examination reports of all major affiliated banks should be conducted. The review process is intended to provide a basis for determining areas of emphasis and follow-up during the inspection. The examiner need not re-examine the insurance program or the controls in force in the individual banks.
3. The examiner should meet with the officer responsible for maintaining the insurance policies and related documentation and ascertain the location of such policies and documentation. Review any independent review of coverages and any deficiencies that may have been cited by the internal or external auditors.
4. Review the manner and frequency of presentations to the board of directors of the insurance coverage.