

# Risk Management

## Introduction

Effective date July 1997

## Section 3000.1

Taking and managing risks are fundamental to the business of banking. The U.S. banking supervisory agencies place significant emphasis on the adequacy of an institution's management of risk, including the establishment of a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business. In a branch, which is typically removed from its head office by location and time zone, an effective risk management system is critical not only to manage the scope of its activities but to achieve comprehensive, ongoing oversight by branch and head office management. In the examination process, examiners will therefore determine the extent to which risk management techniques are adequate (1) to control risk exposures that result from the branch's activities and (2) to ensure adequate oversight by branch and head office management and thereby promote a safe and sound banking environment.

Principles of sound management should apply to the entire spectrum of risks facing a branch including, but not limited to, the following:

- *Credit risk* which arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Country/transfer risk* which encompasses the entire spectrum of risks arising from the economic, social and political environments of a foreign country which may have potential consequences for foreigners' debt and equity investments in that country. More specifically, transfer risk focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt.
- *Market risk* which is the risk to a financial institution resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
- *Liquidity risk* which is the potential that a branch will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions ("market liquidity risk").

- *Operational risk*<sup>1</sup> which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- *Legal risk* which arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of the branch.

### ELEMENTS OF RISK MANAGEMENT

When rating the quality of risk management at branches, examiners should place primary consideration on findings relating to the following elements of a sound risk management system:

- active senior management oversight at the head office, regional management office (if applicable) and local branch levels;
- adequate policies, procedures, and limits; and
- a strong management information system for measuring, monitoring and reporting risks.

Each of these elements is described further below, along with a list of considerations relevant to assessing the adequacy of each element.

Examiners should recognize that the considerations specified in these guidelines are intended only to assist in the evaluation of risk management practices and not as a checklist of requirements for each branch.

Adequate risk management programs can vary considerably in sophistication, depending on the size and complexity of the FBO and its branch network and the level of risk that it accepts. Examiners need to ensure that senior managers at the head office and/or at the regional management office are provided with the information they need to monitor and direct day-to-day activities of the branch.

The risk management processes of branches would typically contain detailed guidelines that

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1. While operational and legal risks are identified as part of the branch's overall risk assessment process, the effectiveness of the branch's operational controls are included in the "O" component of the ROCA rating system assessment. Further, when legal risks potentially result in violations of law or regulation, the "C" component would also be impacted.

set specific prudential limits on the principal types of risks relevant to the FBO's activities worldwide. Reporting systems should comprise an adequate array of reports that provide the levels of detail about risk exposures that are relevant to the duties and responsibilities of senior management at the head office and, where applicable, the regional management office.

The risk management systems will naturally require independent monitoring and testing in addition to review by internal or external auditors to ensure the integrity of the information used by senior officials in overseeing compliance with policies and limits. The risk management systems or units of FBOs must also be sufficiently independent of the business lines in order to ensure an adequate separation of duties and the avoidance of conflicts of interest.

## ACTIVE HEAD OFFICE SENIOR MANAGEMENT OVERSIGHT

As part of its responsibility to provide a comprehensive system of oversight for the branch, the head office has a role in developing and approving a risk management system for the branch. Senior management at the head office, regional management office and local branch levels are responsible for implementing strategies in a manner that limits risks associated with each strategy, and that ensures compliance with laws and regulations on both a long-term and day-to-day basis. Accordingly, branch management should be fully involved in the activities of the branch and possess sufficient knowledge of all major business lines to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated. Management is also responsible for establishing and communicating a strong awareness of and need for effective internal controls and high ethical standards.

In assessing the quality of the oversight by head office, regional and branch management, examiners should consider whether the branch follows policies and practices such as the following:

- Management has identified and clearly understands the types of risks inherent in the activities of the branch and makes appropriate efforts to remain informed about these risks as

financial markets, risk management practices, and the branch's activities evolve. Management periodically reviews risk exposure limits to ensure they are appropriate considering changing circumstances.

- Management has reviewed and approved appropriate policies to limit risks inherent in all significant activities of the branch, including lending, investing, trading, private banking, and trust.
- Management is sufficiently familiar with and is using adequate recordkeeping and reporting systems to measure and monitor the major sources of risk to the branch.
- Management ensures that the branch's areas of activities are managed and staffed by personnel with knowledge and experience consistent with the nature and scope of these activities.
- Management ensures that the depth of staff resources is sufficient to operate and manage the activities of the branch and that branch employees have the necessary integrity, ethical values, and competence.
- Management at all levels provides adequate supervision of the day-to-day activities of all employees, including senior officers.
- Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the branch is active.
- Management identifies and reviews all risks associated with new activities or products and ensures that the branch infrastructure and internal controls in place are adequate to manage related risks prior to commencing new activities or offering new products.

## ADEQUATE POLICIES, PROCEDURES AND LIMITS

Head office management should tailor risk management policies and procedures to the types of risks that arise from the activities the branch conducts. Once the risks are properly identified, the branch's policies and procedures provide detailed guidance for the day-to-day implementation of broad business strategies, and generally include limits designed to shield the branch from excessive or imprudent risks. While all branches should have policies and procedures that address significant activities and risks, the coverage and level of detail in these policies and

procedures will vary among branches. A smaller, less complex branch that has effective management that is actively involved in day-to-day operations generally would be expected to have only basic policies addressing the significant areas of operations and setting forth a limited set of requirements and procedures. In a larger branch, where senior management must rely on widely-dispersed staff to implement strategies in an extended range of potentially complex businesses, far more detailed policies and related procedures would generally be expected. In either case, management is expected to ensure that policies and procedures address the material areas of risk to the FBO and the branch and that they are modified when necessary to respond to significant changes in the branch's activities or business conditions.

In evaluating the adequacy of a branch's policies, procedures and limits, examiners should consider whether:

- The branch's policies, procedures and limits provide for adequate identification, measurement, monitoring and control of the risks posed by lending, investing, trading, private banking, trust and other significant activities.
- The branch's policies, procedures and limits are consistent with the experience level, stated goals and objectives, and overall financial strength of the organization.
- Policies clearly delineate accountability and lines of authority across the branch's activities.

## EFFECTIVE RISK MONITORING AND MANAGEMENT INFORMATION SYSTEMS

Effective risk monitoring requires branches to identify and measure all risk exposures. Consequently, risk monitoring activities must be supported by information systems that provide senior managers at the head office, regional office, and branch with timely reports on the financial condition, operating performance, and risk exposure of the consolidated organization, as

well as with regular and sufficiently detailed reports for line managers to engage in the day-to-day management of the branch's activities.

The sophistication of the risk monitoring and management information systems should be consistent with the complexity and diversity of the branch's operations. Accordingly, smaller and less complicated branches may require only a limited set of management reports to support risk monitoring activities. These reports include, for example, daily or weekly balance sheets and income statements, a watch list for potentially troubled loans, a report for past due loans, a simple interest rate risk report, and similar items. Larger, more complex branches, however, would be expected to have much more comprehensive reporting and monitoring systems that allow, for example, for more frequent reporting, tighter monitoring of complex trading activities, and the aggregation of risks on a fully consolidated basis across all business lines and activities. Branches of all sizes are expected to have risk monitoring and management information systems in place that provide senior management with a clear understanding of the branch's positions and risk exposures.

In assessing the adequacy of the measurement and monitoring of risk as well as management reports and information systems at a branch, examiners should consider whether:

- The branch's risk monitoring practices and reports address all risks.
- Key assumptions, data sources, and procedures used to measure and monitor risk are appropriate, adequately documented and periodically tested.
- Reports and other forms of communication are consistent with the activities of the branch, are structured to monitor exposures and compliance with established limits, goals and objectives, and, as appropriate, compare expected to actual performance.
- Reports to head office are accurate and timely and contain sufficient information for senior management to identify any adverse trends and to evaluate the level of risk assumed by the branch.

### CREDIT RISK

This section is devoted to credit risks associated with direct lending arrangements. The comprehensiveness of a credit risk management system will depend upon the sophistication and types of credit-related activities being conducted by the branch. In some circumstances, a branch may have no independent lending authority and may simply serve as a booking office for loans approved by the head office. A more active branch may, however, have an independent credit review department and established lending authorities. Therefore, credit policies, procedures, and documentation may vary significantly.

This section will assist the examiner in performing two separate, but interrelated, procedures:

- The evaluation of the depth and scope of formalized policies and procedures used by the branch to manage and control its credit risks.
- An overview of the performance of the branch's entire lending operations by evaluating the results of all lending departments.

### Branch Credit Administration Policies

As part of the analysis of a branch's loan portfolio, examiners review credit policies, credit administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation is essential to the institution's management of the lending function.

The policies and procedures governing a branch's lending activities must be clearly communicated to management and lending staff. These policies and procedures must define prudent underwriting standards, credit risk controls, prudent internal limits, and an effective credit review and risk identification process. The complexity and scope of these policies and procedures should be appropriate to the size and nature of the branch's activities, and should be consistent with prudent banking practices and applicable federal and state laws and regulations.

The establishment of a written lending policy provides the foundation for sound loan portfolio

management. Throughout this manual there is considerable emphasis on the establishment of formal written policies to guide and manage the scope of the branch's activities within acceptable risk parameters, and to achieve comprehensive, ongoing oversight by branch and head office management. This is perhaps the most important element in the branch lending function. The banking organization, in discharging its duty to both the depositors and shareholders, must ensure that loans in the branch portfolio are made in accordance with the following two objectives:

- To grant loans to creditworthy borrowers for constructive purposes.
- To grant loans that generate income for the benefit of shareholders and the protection of depositors, and in the case of branches, the protection of third parties.

A loan policy will differ from loan procedures. Branches need both to adequately address all areas of lending and loan administration. The lending policy should contain a general outline of the scope of the branch's credit facilities and the manner in which loans are made, serviced, and collected. The policy should be broad in nature and not overly restrictive. The formulation and enforcement of inflexible rules not only stifles initiative but also may hamper profitability and prevent the branch from serving customers' changing needs. A lending policy should provide for the presentation to the head office or a committee thereof, of loans that credit officers believe are fundamentally sound and worthy of consideration, even though they may not conform with certain aspects of the branch's written lending policy. Any exceptions to the lending policy should be approved, documented, monitored and reported to head office. Flexibility must exist to allow for fast reaction and early adaptation to changing conditions in the branch's earning assets mix and within its service area.

The written loan policy is the cornerstone for sound lending and loan administration. An adequate loan policy serves to promote:

- Consistency in business and lending philosophy, despite changes in management.
- Stability as it provides a reference for lending authorities.

- Clarity to minimize confusion concerning lending guidelines.
- Objectivity as it provides sound guidelines for evaluating new business opportunities.

In developing the lending policy, consideration must be given to the branch's business plan, financial resources, and personnel. Typically, a branch's lending policy will be used to describe the branch's mission statement, e.g., facilitating trade transactions with the home country and lending to U.S. subsidiaries of home country corporations.

A lending policy should prohibit discriminatory practices. However, a policy should identify acceptable and unacceptable types of credit and establish prudent underwriting standards, including pricing standards. Other internal factors addressed include granting credit authority, establishing lending limits, and defining organizational structure. As authority is spread throughout its offices, the organization must have an effective method for monitoring adherence to established policy. The testing of credit quality standards can best be accomplished by an internal loan review and reporting function to the head office, which allows senior head office management to monitor adherence to policies and provides information sufficient to evaluate the performance of branch officers and the condition of the loan portfolio. The audit function can also serve to enforce compliance with policies, guidelines, and approved credit administration practices.

## Components for a Sound Lending Policy

The lending policy should require diversification within the portfolio and provide prudent underwriting standards. There are certain components that form the basis for a sound loan policy and should be addressed by every lending institution.

*Aggregate Limits and Distributions by Category*—In order to limit the total amount of loans outstanding, relationships with other balance sheet accounts should be established. Branches usually express controls over the loan portfolio relative to their total claims on nonrelated parties. In setting such limits, various factors, such as credit demand, legal lending

limit, borrower or industry concentration, the volatility of funding and the credit risks involved must be considered. Additionally, limits on aggregate percentages of total loans in commercial, real estate, consumer, or other categories are common. Such policies are beneficial but should allow for deviations with the approval by the head office. This allows credit to be distributed in relation to the changing needs of the target markets.

*Geographic Limits*—A branch's trade area should be clearly delineated and loan officers and senior management should be fully aware of specific geographic limitations for lending purposes. Although many branches will define their trade areas to include a number of states, frequently, the primary calling efforts are focused on a narrower area. Certain types of lending, which require significant knowledge of local market conditions or intensive monitoring of branch personnel, should be carefully considered. Examples include commercial loans to large regional companies, loans to finance commercial real estate projects, or asset based lending that requires regular monitoring of accounts receivables. In addition, the branch's defined trade area should not be so large that, given its resources, proper and adequate monitoring and administration of the branch's credits cannot be reasonably determined.

*Concentrations of Credit*—The loan policy should recognize the need for diversification of risk and establish some parameters on concentrations of loans to industries, related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry.

Examiners should recognize that as a part of a larger banking entity, individual branches may have concentrations that are well within proper diversification in the context of the overall organization. Many branches specialize in terms of the kind of business transacted and the types of credits extended. Many credits are trade-related and often reflect the economic makeup of the branch's home country. In addition, credits at the branch are often booked at the direction of the head office and can reveal concentration by industry, country, or borrower. Nonetheless, branches, as part of a sound risk management system, must establish procedures for identifying

and monitoring inherent risk resulting from concentrations of credit.

Institutions that have effective controls in place to manage and reduce undue concentrations need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location. It is important to emphasize that this principle applies to loan renewals, rollovers, and new extensions of credit.

*Types of Loans*—The lending policy should state the types of loans that the branch will make and should set forth guidelines to follow in making specific loans. The decision about the types of loans to be granted should be based on a consideration of the business plan, expertise of the lending officers and support personnel, the funding structure of the branch, and anticipated credit demands of the target markets. Credits involving complex structures or repayment arrangements or loans secured by collateral that require more than normal policing should be avoided unless or until the branch obtains the necessary personnel, policies, controls, and systems to properly administer such loans. Types of credits that have resulted in an abnormal loss to the branch should be identified, scrutinized, and controlled within the framework of stated policy.

*Repayment Terms and Maximum Maturities*—Loans should be granted with realistic repayment plans. Maturity scheduling should be related to the anticipated source of repayment, the purpose of the loan, and the useful life of the collateral. For term loans, a lending policy should state the maximum number of months over which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modification of the original terms of a loan. If the branch requires a cleanup (out-of-debt) period for lines of credit, the period should be explicitly stated.

*Loan Pricing*—Rates on various loan types established by the loan policy must be sufficient to cover the costs of the funds loaned, of servicing the loan, including general overhead and of probable losses while providing for a reasonable margin of profit. Policy makers must know those costs before establishing rates that arise out of an effective risk management process. Periodic review allows the rates to be adjusted to reflect changes in costs, competitive factors, or the risks associated with the type of extension of credit. Specific guidelines for other

relevant factors, such as commitment fees, are also germane to pricing policy.

*Documentation and Collateral*—Trade financing often represents a significant amount of the branch's lending activity. In such financing, the branch deals only in documents while its customer is responsible for the merchandise under the terms of the contract. The branch's control of documents, especially title documents, is crucial. There are significant differences between domestic loan agreements and foreign ones. Nevertheless, the branch must ensure that it is adequately protected through loan agreements with foreign borrowers. The loan agreement should also protect against adverse changes in foreign tax rules, loan funding problems, and additional withholding and other types of taxes. The branch should have policies for taking foreign collateral as security for a loan to assure adherence with the local required procedures. For example, liens on fixed assets in many countries must be registered with the local government.

*Maximum Ratio of Loan Amount to Collateral Value or Acquisition Costs*—The branch's lending policy should identify where the responsibility for appraisals or internal evaluations lies and should define formal, standard appraisal, and evaluation procedures, and procedures for possible reappraisals or reevaluations in the case of renewals or extensions. Acceptable types of appraisals or evaluations should be listed. The policy should also include the limits on the dollar amount and type of real or personal property that branch personnel are authorized to appraise. Circumstances regarding the use of in-house appraisers versus a fee appraiser should be identified. The ratio of loan amount to the value of the collateral, the method of valuation, and the differences for various types of property should be detailed.

*Financial Information*—Extending credit on a safe and sound basis depends on complete and accurate information regarding the borrower's credit standing. One exception is when the loan is predicated on readily marketable collateral, the disposition of which was originally designated as the source of repayment for the advance. Current and complete financial information is necessary not only at the inception of the credit but also throughout the term of the credit. The lending policy should define the requirements of

financial statement information for various types of credit extended by the branch. In addition, the lending policy should define the requirements for financial statements and operating data for businesses and individuals at various borrowing levels and should include requirements for audited, non-audited, annual, interim, income, cash flow and other financial statements, tax returns, changes in owner's equity and other supporting notes, schedules, and management analyses. Financial statement requirements should include external credit checks required at the time of periodic updates. The policy should define the financial requirements in such a manner that any credit data exception in an examination report should be a clear contravention of the branch's lending policy.

Financial statements for foreign borrowers or guarantors may present additional risks or problems not associated with domestic borrowers. Foreign customers' financial statements may be prepared in either U.S. dollar equivalents or in the borrower's local currency. Most branches analyze the latter statements, particularly if that currency is unstable, therefore figures stated in U.S. dollar equivalent amounts would be distorted by the conversion rates used at various times. Sometimes, the branch may need to reconstruct a borrower's financial statement in U.S. dollar equivalents to reflect the borrower's financial strength and weaknesses more accurately. Since the financial information may not be reliable, the branch's policies should enable it to determine by other means the capacity, integrity, and experience of the foreign borrower. While analyzing foreign borrowers' financial statements, examiners should take into consideration the differences in foreign accounting practices from the generally accepted accounting principles (GAAP) in the United States.

*Limits on Country Exposures*—The loan policy should define maximum exposures to countries other than the United States. All sizeable exposures should be supported by country analyses and other supporting information. Country limits should be consistent with the creditworthiness of the respective countries.

*Limits and Guidelines for Purchasing and Selling Loans Either Directly or Through Participations or Swaps*—If sufficient loan demand exists, lending within the branch's trade area is safer and less expensive than purchasing paper from another bank. Direct lending promotes

customer relationships, serves the credit needs of customers, and develops additional business. In some instances, however, a branch may not be able to make a loan to a customer for the full amount requested because of prudential lending limitations or other reasons. In such situations, the branch may extend credit to its customer for the full amount needed and sell or participate out that portion that exceeds the branch's lending limit or the amount it wishes to extend on its own. Generally, such sales arrangements are established before the credit is ultimately approved. These sales should be on a nonrecourse basis to the branch and the originating and purchasing institutions should share in the risks and contractual payments on a pro rata basis. Selling or participating out portions of loans to accommodate the credit needs of customers promotes goodwill and enables a branch to retain customers who might otherwise seek credit elsewhere.

Conversely, many branches purchase loans or participations in loans originated by other organizations. The policy should require that loans purchased from another source be evaluated in the same manner as loans originated by the branch itself. Generally, the branch should avoid concentrations in purchasing loans from any one outside source or concentrations in purchases of loans to any one industry.

Purchasing and selling loans can have a legitimate role in a branch's asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities can assist a branch in diversifying its risks and improving its liquidity.

The policy should state the limits for the aggregate amount of loans purchased from and sold to any one outside source and for all loans purchased and sold. Limits should also be established for the aggregate amount of loans to particular types of industries that may be purchased. Guidelines should be established for the type and frequency of credit and other information that should be obtained from the lead institution in order to keep the branch continually updated on the financial condition of the borrower and the status of the credit. Because of the inherent reliance on the lead institution to administer and collect participated loans, the purchasing branch should evaluate the lead institution's ability to properly carry out these responsibilities. Conversely, guidelines should also be established for supplying complete and regularly updated credit information to the

purchasers of loans originated and sold by the branch.

*Loan Authority*—The lending policy should establish limits for all lending officers. In many branches of FBOs, most lending authority remains with the head office. If lending policies are clearly established and enforced, individual officer limitations may be somewhat higher, based on the officer's experience and tenure with the branch. Frequently, group lending limits are set, allowing a combination of officers or a committee to approve larger loans than the members would be permitted to approve individually. The reporting procedures and the frequency of committee meetings should be defined.

*Collections, Charge-Offs, and Specific Reserves*—The lending policy should define delinquent obligations and contain guidelines for placing loans on nonaccrual status and initiating foreclosure proceedings. Delinquency status is determined by the contractual terms and defined as when the principal or interest on an asset becomes due and unpaid for 30 days or more. For regulatory reports, branches must comply with the reporting requirements for past due and nonaccrual loans. Additionally, the policy should dictate the appropriate reports to be submitted to the head office concerning those obligations. The reports should include sufficient detail to allow for the determination of the loss potential and alternative courses of action. The policy should require a follow-up collection notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the head office for charge-offs or specific reserves in accordance with applicable regulatory policy.

*Legal Lending Limits*—The lending policy may describe limitations on loans to one borrower, as are consistent with head office and/or federal requirements. The Foreign Bank Supervision Enhancement Act of 1991 superseded state legal lending limits to the extent that exposures to a single borrower by all state and federal branches of the same FBO must be aggregated and applied against the capital of the FBO (12 USC 84.)

*Other*—The lending policy should be supplemented with other written guidelines for specific departments of the branch. Written policies and

procedures approved and enforced in various departments should be referenced in the general lending policy of the branch.

Management should establish appropriate policies, procedures, and information systems to ensure that the impact of the branch's lending activities on its interest rate exposure is carefully analyzed, monitored, and managed. In this regard, consideration should also be given to the risks associated with off-balance sheet instruments related to lending arrangements, such as loan commitments and swaps.

## Approval Process

In addition to the components that form the basis for a sound lending policy, there should be a documented approval process for exceptions to that policy, including the need for approval of exceptions by the head office. Management information systems should report and highlight loan exceptions to branch management and the head office.

Before a branch extends credit, its objectives, policies, and practices must be clearly established. Before examining a loan department, those objectives, policies, and practices should be reviewed by the examiner to determine if they are reasonable and adequate to properly supervise the portfolio. The absence of written guidelines is a major deficiency in the lending area and may indicate that the branch is not being properly supervised by its head office. The various credit extending areas should be examined to determine compliance with objectives, policies, and practices, which is a prime examination objective.

## Loan Information Systems

The loan information system should include the loan policy and loan administration procedures, loan documentation maintained for borrowers, reports prepared for the benefit of senior management at the branch or at the head office, the loan grading and loan review system, and the system to manage problem loans.

Loan information and documentation should demonstrate that the borrower has the ability and willingness to repay the loan. These documents should also indicate that the lending officer has adhered to sound lending practices,

acted prudently to safeguard the branch's funds, and ensured repayment of the loan by all reasonable means. Loan information and other documentation supporting an extension of credit should be in English to enable the examiner to properly evaluate the quality of the credit.

In general, loan documents should provide answers to the following questions:

- Who is the borrower, including ownership and affiliations?
- How did the borrower come to the branch?
- What is the borrower's business?
- What is the purpose of the credit?
- What are the primary and secondary sources of repayment?
- What is the borrower's financial condition?
- What are projections for the borrower's future financial performance?
- How has the borrower performed on other credit obligations?
- What is the collateral for the loan, its location, value, and condition?

If guarantees are involved, the branch must have sufficient information on the guarantor's financial condition. Income, liquidity, cash flows, contingent liabilities, and other relevant factors should be evaluated, including credit ratings, when available, to demonstrate the guarantor's financial capacity to fulfill the obligation. Generally, however, loan quality should be evaluated based on the primary source of payment not secondary sources, such as guarantees. In this respect, guarantees from head office are not viewed as providing support to a loan.

An effective system to obtain and maintain complete and current loan information and documentation is a necessary component of sound lending. Failure to establish and enforce this system will increase credit risk and cause the branch to suffer losses that could have been avoided.

Before the loan is funded, the branch must ensure that all the required documentation is current. It is generally easier to ensure complete and current documentation before the loan is funded, as the borrower will be cooperative and the loan has the lending officer's full attention.

To ensure on-going attention to documentation, the loan policy should require the branch to obtain and maintain current documentation on borrowers and collateral. The loan policy should also ensure that loan documentation is reviewed

periodically and any exceptions are addressed promptly.

## INTERNAL LOAN REVIEW

### Key Loan Review Objectives

Depending on the branch's size, its lending activities, and management philosophy, loan review may be handled by a part-time person, one person, an independent contractor, or a separate department staffed by a number of employees at the branch, at a regional U.S. office, or at the head office. An important ingredient of loan review is that it must be independent from the approval process. Regardless of how loan review is structured, a satisfactory loan review system should have the following objectives:

- Provide an objective grading system for loans.
- Provide current information regarding portfolio risk to branch management and the head office on a timely basis.
- Identify problem credits and place them under additional scrutiny.
- Assist in the evaluation of the adequacy of specific and general reserves in accordance with applicable regulatory policy.<sup>1</sup>
- Evaluate trends in the loan portfolio.
- Cite loan policy exceptions and noncompliance with procedures.
- Cite documentation exceptions.
- Cite violations of laws and regulations.
- Assist in the development and revision of policy and procedures.
- Act as an information source concerning emerging trends in the portfolio and the branch's lending areas.

### Loan Review Reporting

Loan review reporting must be thorough, accurate, and timely to provide sufficient information to allow management and the head office to both

1. Branches are not required to maintain an allowance for loan losses for Federal Reserve supervisory purposes. However, it is recognized that the licensing and insuring authorities may require U.S. branches to maintain such reserves under their respective jurisdictions to fulfill the requirements of their individual licensing or insurance statutes, or to satisfy other specific concerns of the authority.

identify and control risk. At a minimum, there should be three types of reporting required from loan review: file memoranda, head office reports, and an annual schedule or loan review plan.

File memoranda are completed after each loan is reviewed and are placed in the credit file to document the reviewer's conclusions. Loan grades and supporting facts should be included, along with any instances of noncompliance with the branch's policy, procedures and applicable regulations. Documentation exceptions should also be indicated.

If the process is conducted by the lending officers themselves, then compliance with policies and procedures is best determined by another branch department, such as internal audit.

Head office/management reports are summaries of the loan reviewer's conclusions regarding the quality of the portfolio or segment of the portfolio. These reports should state the scope of the review; the distribution of loan grades for the portfolio or segment of the portfolio; the percentage of both collateral and financial documentation exceptions; all instances of noncompliance with policies, procedures, or regulations; an assessment of the overall quality of the portfolio; and the resulting impact on the allowance for loan losses, where applicable, and any other factors that might have an adverse effect on the portfolio.

These reports should go to head office management. If applicable, a copy of these reports can also be given to U.S. regional management, the manager of the loan department, and the branch's executive management; however, management should not be allowed to influence the content of the report. The head office should be given this report on a timely basis and require lending officers to correct and respond to all significant problems and exceptions within a specified time frame.

Although a good loan review system is important to ensure sound lending and strong loan administration, excessive reliance should not be placed on this system. It is always the lending officers' responsibility to maintain sound underwriting standards and loan quality. It is also their responsibility to monitor the portfolio on an ongoing basis and to initially identify problem credits. Loan review should not be the first line of defense to identify emerging problems. Its primary responsibility is to identify weaknesses in lending and loan administration and their underlying causes.

## Loan Problems

The failure of branch and head office management to establish a sound lending policy, to establish adequate written procedures, and to monitor and administer the lending function within established guidelines may result in substantial problems for the branch. Loan problems may be caused by a number of factors affecting the branch or its borrowers, such as the following:

*Anxiety for Income*—The loan portfolio is usually the branch's most important revenue producing asset. However, the pursuit of earnings must never be permitted to override sound underwriting principles by extending credit that carries undue risks or unsatisfactory repayment terms. Over the long term, unsound loans usually cost far more than the revenue they produce.

*Compromise of Credit Principles*—Branch management, for various reasons, may knowingly grant loans carrying undue risks or unsatisfactory terms in violation of its own underwriting standards. These reasons may include head office relationships with associated companies of the branch's customer. Self-dealing, anxiety for income, inappropriate salary incentives, bonuses based on loan portfolio growth, and competitive pressures may also lead to a compromise of sound credit principles.

*Incomplete Credit Information*—Character and capability may be determined by many means but complete credit information is the only acceptable and reasonably accurate method for determining a borrower's financial condition. The lack of sufficient financial information is an important cause of problem credits. Current and complete comparative financial statements, operating reports, and other pertinent statistical support should be available. Other essential information, such as the purpose of the borrowing, the intended plan and source of repayment, progress reports, inspections, and memoranda of outside information and loan conferences, should be contained in the branch's credit files. Proper credit administration and accurate credit appraisals are not possible without such information.

The Interagency Policy on Documentation of Loans by U.S. Branches and Agencies of Foreign Banks, which was issued on May 14, 1993,

exempts these branches from certain documentation requirements for credits to small and medium-sized businesses and farm loans. (Refer to the policy statement for specific limitations.)

*Failure To Obtain or Enforce Repayment Agreements*—Loans granted without a clear written agreement governing repayment violate a fundamental banking principle that frequently is a major cause of problem loans. Another common cause of problem loans is when scheduled payments or reductions are not collected in accordance with the terms of the loan agreement.

*Inadequate supervision of familiar borrowers.*

*Over-reliance on verbal information furnished by borrowers in lieu of reliable financial data.*

*Downplaying of known credit weaknesses because of the borrower's past history of overcoming recurrent hazards and distress.*

*Ignoring warning signs pertaining to the borrower, economy, region, industry, or other related factors.*

*Lack of Supervision*—Many loans that are sound at inception have developed into problems and losses because of lack of effective on-going supervision.

*Technical Incompetence*—Able and experienced bankers should possess the technical ability to analyze financial statements and to obtain and evaluate other credit information. Technical incompetence often results in unexpected losses.

*Overlending*—Loans granted beyond the borrower's reasonable capacity to repay are inherently unsound. Technical competence and sound credit judgment are necessary in determining a sound borrower's safe, maximum loan level.

*Competition*—Competition among branches for size and market share may result in the compromise of credit principles and the funding of unsound loans.

## Nonaccrual and Restructured Loans

Working in a prudent manner with borrowers that are experiencing financial difficulties, branch

management may restructure loans or take other measures in recognition of borrowers' condition and repayment prospects. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve a branch's prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements provide a framework for working in a constructive fashion with borrowers experiencing financial difficulties.

The Interagency Policy Statement on Credit Availability, issued on March 1, 1991, presented clarifications of a number of supervisory policies regarding issues relating to nonaccrual assets and restructured loans. These clarifications indicated that when certain criteria are met: (a) interest payments on nonaccrual assets can be recognized as income on a cash basis, without first recovering any previous partial charge-offs; (b) nonaccrual assets can be restored to accrual status when subject to formal restructuring in accordance with Financial Accounting Standards Board (FASB) Statement No. 15; and (c) restructuring that yields a market rate of interest would not have to be included in restructured loan amounts reported in the years subsequent to the year of the restructuring.

## Nonaccrual of Interest

Loans and lease financing receivables are to be placed in nonaccrual status if:

- They are maintained on a cash basis because of deterioration in the financial condition of the borrower.
- Payment in full of principal or interest is not expected; or
- Principal or interest has been in default for a period of 90 days or more, unless the loan is both well secured and in the process of collection.

A debt is well secured if it is secured (a) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt, including accrued interest, in full, or (b) by the guarantee of a financially responsible party. A debt is in the process of collection if collection of the asset is proceeding in due course either through legal action,

including judgment enforcement procedures or, in appropriate circumstances, through collection efforts not involving legal action, which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

*Treatment of Cash Payments and Criteria for the Cash Basis Recognition of Income*—When doubt exists as to the collectibility of the remaining book balance of a loan in nonaccrual status, any payments received must be applied to reduce principal to the extent necessary to eliminate such doubt. Placing an asset in nonaccrual status does not, in and of itself, require a charge-off, in whole or in part, of the asset's principal. However, identified losses must be charged-off. When a loan is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis if the remaining book balance of the asset, after a charge-off, if any, is deemed to be fully collectible. A branch's determination as to the ultimate collectibility of the asset's remaining book balance must be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's historical repayment performance and other relevant factors.

When recognition of interest income on a cash basis is appropriate, the amount of income that is recognized should be limited to that which would have been accrued on the loan's remaining book balance at the contractual rate. For a formally restructured loan, the effective interest rate should be used. Any cash interest payments received in excess of this limit, and not applied to reduce the loan's remaining book balance, should be recorded as recoveries of previous charge-offs, until these charge-offs have been fully recovered.

*Restoration to Accrual Status*—According to the Revised Interagency Guidance on Returning Certain Nonaccrual Loans to Accrual Status issued June 10, 1993, nonaccrual loans may be returned to accrual status, even though the loans have not been brought fully current, provided two criteria are met: (1) all principal and interest amounts contractually due, including arrearages, are reasonably certain of repayment within a reasonable period and (2) there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in

accordance with the contractual terms, involving payments of cash or cash equivalents. However, loans that meet these criteria would continue to be disclosed as past due and still accruing for purposes of the Report of Assets and Liabilities (call report), until they have been brought fully current.

For purposes of meeting the first test, the branch must have received repayment of the past due principal and interest unless, as discussed below, the loan has been formally restructured and qualifies for accrual status or the asset has been acquired at a discount (because there is uncertainty as to the amounts or timing of future cash flows) from an unaffiliated third party and meets the criteria for amortization, i.e., accretion of discount, specified in AICPA Practice Bulletin No. 6.

Until the loan is restored to accrual status, cash payments received must be treated in accordance with the criteria stated above. In addition, after a formal restructuring, if a restructured loan that has been returned to accrual status later meets the criteria for placement in nonaccrual status as a result of past due status based on its modified terms or for any other reasons, the asset must be placed in nonaccrual status. Under GAAP, when a charge-off was taken before the date of the restructuring, the charge-off does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed in the previous paragraphs in this section are applicable.

*Treatment of Multiple Extensions of Credit to One Borrower*—As a general principle, nonaccrual status for an asset should be determined based on an assessment of the individual asset's collectibility and payment ability and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a branch does not have to place all other extensions of credit to that borrower in nonaccrual status. When a branch has multiple loans or other extensions of credit outstanding to a single borrower, and one loan meets the criteria for nonaccrual status, the branch should evaluate its other extensions of credit to that borrower to determine whether one or more of these other assets should also be placed in nonaccrual status.

*Examiner Review*—Some states have promulgated regulations or adopted policies for

nonaccrual of interest on delinquent loans, which may differ from the above procedures. In such cases, the branch should comply with the more restrictive policy. The examiner should ensure that the branch is complying with such guidelines. In all instances, whether or not there is a formal policy, each branch should formulate its own policies to ensure that income is not being overstated. The examiner should review the branch's specific policy to ensure that it is prudent.

When a branch places a loan in nonaccrual status, it must determine an appropriate treatment for previously accrued but uncollected interest and subsequent payments. One acceptable method is to reverse all previously accrued but uncollected interest against appropriate income and balance sheet accounts. For interest accrued in the current accounting period, the entry is made directly against the interest income account. For prior accounting periods, all interest previously recognized, if accrued interest provisions had not been provided, would be reversed (expensed) against current earnings.

Generally accepted accounting principles do not require the write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. A branch is expected to have a well-defined policy governing the write-off of accrued interest receivable.

### Treatment of Nonaccrual Loans with Partial Charge-offs

Questions have been raised regarding whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must first be fully recovered before a loan can be restored to accrual status. GAAP and regulatory reporting requirements do not explicitly address this issue.

When a loan has been brought fully current with respect to contractual principal and interest and the borrower's financial condition and prospects for repayment have improved so that the full amount of contractual principal, including any amounts charged-off, and interest is expected to be repaid, the loan may be restored to accrual status without having to first recover the charge-off. On the other hand, this treatment would not be appropriate when the charge-off is indicative of continuing doubt regarding the collectibility of principal or interest. Because the criteria for

nonaccrual status include the requirement that loans or other assets be placed in nonaccrual status when repayment in full of principal or interest is not expected, such nonaccrual loans should not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be documented. Such actions should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal, including any amounts charged-off, and interest. This documentation will be subject to review by examiners.

### Renegotiated Troubled Debt

Renegotiated troubled debt includes those loans and lease financing receivables that have been restructured or renegotiated to provide concessions to the borrower, e.g., a reduction of interest or principal payments because of a deterioration in the financial position of the borrower. A loan extended or renewed at a stated rate equal to the current interest rate for new debt with similar risk is not considered renegotiated debt. For further information, see Financial Accounting Standards Board Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructuring, (FASB Statement No. 15).

Branches should develop a policy relative to renegotiated troubled debt to ensure that such items are identified, monitored, and properly handled from an accounting and control standpoint. Such items should be relatively infrequent in occurrence. If not, the branch is probably experiencing significant problems. Before such concessions are made to a borrower, it is good practice to have the transactions receive prior approval of the head office. All such transactions should be reported to the head office upon enactment.

### Nonaccrual Assets Subject to FASB Statement No. 15 Restructuring

The Policy Statement on Credit Availability Issues indicated that a loan or other debt instrument that has been formally restructured, so as to be reasonably certain of repayment and

performance according to its modified terms in accordance with a reasonable repayment schedule, need not be maintained in nonaccrual status. Furthermore, the policy statement indicated that, in returning the asset to accrual status, sustained historical payment performance for a reasonable time before the restructuring may be taken into account.

For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. In so doing, the borrower's restructured terms may require payments that do not exceed the amount and frequency that have been demonstrated by the sustained historical payment performance of the borrower for a reasonable time before the loan was restructured. In this situation, assuming that the restructured loan is reasonably certain of repayment and performance according to its modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether before or after the date of the restructuring, is an important factor in determining whether there is reasonable assurance of repayment and performance according to the loan's modified terms. In certain circumstances, evidence may exist regarding other characteristics of the borrower that may be sufficient to demonstrate a relative improvement in the borrower's condition and debt service capacity, thereby reducing the degree of reliance on the borrower's performance to date in assessing prospects for future performance and collectibility under the modified terms. For example, substantial and reliable sales, lease, or rental contracts obtained by the borrower, or other important developments that are expected to significantly increase the borrower's cash flow and debt service capacity and strengthen the borrower's commitment to repay, may be sufficient to provide this assurance. In certain circumstances, a preponderance of such evidence, in and of itself, may be sufficient to warrant returning a restructured loan to accrual status, provided the loan under its restructured terms is reasonably certain of performance and full collectibility.

It is imperative that the reasons for the restoration of restructured debt to accrual status be fully documented. Such actions should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This documentation will be subject to

review by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule. When a restructured loan is not reasonably certain of repayment and performance under its modified terms in accordance with a reasonable repayment schedule, the loan may not be restored to accrual status.

When restructuring loans, regulatory reporting requirements and GAAP do not require banking organizations to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay in order to use the reporting treatment specified in FASB Statement No. 15. Furthermore, regulatory reporting requirements and GAAP do not preclude institutions from including prudent contingent payment provisions in the restructured terms that permit an institution to obtain appropriate recovery of concessions involved in the restructuring, should the borrower's condition substantially improve.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with FASB Statement No. 15 so that it meets the criteria for restoration to accrual status presented in the previous section that addresses restructured loans. Under GAAP, when a charge-off was taken before the date of the restructuring, the charge-off does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed in the previous paragraphs in this section are applicable.

## Reporting of Loan Fees and Interest

The accounting standards for nonrefundable fees and costs associated with lending, commitments to lend, and purchasing a loan or group of loans, are set forth in FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases. The statement applies to all types of loans and to debt securities but not to loans or securities carried at market value and to all types of lenders. It must be applied to all lending and leasing transactions in fiscal years beginning after December 15,

1987, but retroactive application is permitted. For further information, see FASB Statement No. 91.

All other lending-related costs, whether or not incremental, should be charged to expense as incurred, including costs related to activities performed by the lender or by independent third parties for the lender, for advertising, identifying potential borrowers, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Employees' compensation and fringe benefits related to these activities, unsuccessful loan origination efforts, and idle time should be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and should be charged to expense as incurred.

Net unamortized loan fees represent an adjustment of the loan yield and shall be reported in the same manner as unearned income on loans, i.e., deducted from the related loan balances, to the extent possible, or deducted from total loans in any unearned income on loans in the call report, which provides a breakdown of various types of loans. Net unamortized direct loan origination costs shall be added to the related loan balances. Amounts of loan origination, commitment, and other fees and costs recognized as an adjustment of yield should be reported under the appropriate Interest income item in the income statement. Other fees, such as fees that are recognized during the commitment period or included in income when the commitment expires, i.e., fees, retrospectively determined, and fees for commitments, where exercise is remote, and (b) syndication fees that are not deferred, should be reported as other noninterest income.

## Other Lending Concerns

The transfer of low quality loans from one depository institution to another may be made to avoid detection and classification during regulatory examinations. Transfer may be accomplished through participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Examiners should be alert to situations where a branch's intention seems to be the concealment of low quality

assets for the purpose of avoiding examination scrutiny and possible classification.

During branch examinations, examiners should identify situations where low quality assets have been transferred between the branch being examined and another U.S. branch of a foreign bank or other depository institution. Low quality loans, broadly defined, include loans that are classified or specially mentioned or if subjected to review would most likely be classified or specially mentioned, past due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other loans that the examiner believes are of questionable quality.

## Examining the Lending Function

The results of the loan examination should provide the examiner with a method of arriving at an overall evaluation for the entire branch loan portfolio. Historically, examination results have identified problems in the loan area through a detailed review of credits and credit documentation. The examiner should also correlate the following items with the overall system of policies, practices, procedures, and controls instituted by the branch to prevent such problems:

- Identified problem credits.
- Unsafe or unsound lending procedures.
- Past due loans.
- Credit documentary exceptions.
- Violations of laws and regulations.
- Concentrations of credit.
- Evidence of self-dealing loan transactions.
- Collateral documentary exceptions.

The purpose of this correlation is to determine causes of existing problems and weak situations, which represent a potential weakness in the branch's risk management process.

The examiner performing the procedures in this section should make the final decision as to the quality of the entire portfolio, the quality of management review and controls, and the scope and adequacy of internal guidelines. A great deal of judgment is necessary in making those decisions because they significantly affect the overall conclusions reached by the examiner-in-charge. The process of compiling information generated, analyzing it, and formulating conclusions about the causes of existing deficiencies,

requires considerable thought and judgement on the part of the examiner. The ultimate conclusions concern the risk management of the lending function, as it now exists, and as it is projected for the future. Furthermore, the examiner is expected to discern causes of existing and potential problems, to capulize the causes and effects, and to present the problems to branch management in such a manner as to obtain positive corrective action.

## Regulatory Compliance

Branches are expected to comply with laws, regulations, and applicable regulatory policy in all aspects of their lending programs. Moreover, branches should establish adequate internal controls to detect deficiencies or exceptions to their lending policy that result in unsafe and unsound lending practices. In regard to applicable lending limits, the examiner should review the branch's lending practices in accordance with the applicable state laws in the following areas that prescribe limits on aggregate advances to a single borrower and related borrowers.

*Commissions or Gifts for Procuring Loans.* A branch officer, employee, agent, or attorney should not receive anything of value for procuring or endeavoring to procure a loan, which is prohibited under 18 USC 215.

*Political Contributions.* Loans made in connection with any election to any political office should comply with applicable state banking laws and regulations and with the Foreign Corrupt Practices Act of 1977 (Pub. L. 95-213, 91 Stat. 1494 (1977), 15 USC 78dd-1 and 2, 78m, 78o, and 78ff) and the Federal Election Campaign Act (2 USC 441b).

*Loans to Executives, Officers, and Principal Shareholders of Correspondent Banks.* No preferential treatment should be given to loans to insiders of correspondent banks nor should there be the appearance of a conflict of interest. The branch should comply with Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)).

*Appraisals and Evaluations.* Federally-insured branches should obtain an appraisal or evaluation for all real estate-related financial transactions prior to making the final credit decision in conformance with Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) (12 USC 3310, 3331-3351). Appraisal and evaluation requirements are separately discussed in the Real Estate Appraisals and Evaluations part of this section.

*Consumer Compliance.* The residential lending program at a federally-insured branch should ensure that the loan applicant is adequately informed of the annual interest rate, finance charges, amount financed, total payments, and repayment schedule, as mandated in the Federal Reserve's Regulation Z, Truth in Lending (12 CFR 226). The federally insured branch's process for taking, evaluating, and accepting or rejecting a credit application is subject to the Federal Reserve's Regulation B, Equal Credit Opportunity (12 CFR 202).

*Credit Life Insurance Income.* The branch's sale of mortgage life insurance in connection with its real estate lending activity should comply with the sales practices, sales commission limits, and disclosure requirements as defined in the Federal Reserve's policy statement on the disposition of credit life insurance income (67 Federal Reserve Bulletin 431 (1981), FRRS 3-1556).

# Credit Risk Management

## Examination Objectives

Effective date July 1997

## Section 3010.2

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1. To determine if policies, practices, procedures, and internal controls regarding credit risk management are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit and loan review functions.
4. To determine the overall quality of the loan portfolio and how that quality relates to the risk management function of the branch.
5. To prepare information regarding the branch's lending function in concise reportable format.
6. To determine compliance with applicable laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of applicable law or regulations have been noted.

# Credit Risk Management

## Examination Procedures

Effective date July 1997

## Section 3010.3

The following procedures are intended to determine that the branch under examination has established satisfactory procedures to ensure that controls regarding credit risk management are adequate. Examiner discretion is required in applying these procedures. Before beginning the assignment, the examiner should review the scope memorandum and consult with the examiner-in-charge or other designated individual to determine the scope of the review. Some of the procedures may not be necessary, based on the quality of the branch's internal controls or the nature and level of activity in the area.

1. If selected for implementation, complete, or update the Internal Control Questionnaire for this section.
2. Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
3. Reconcile the customer central liability ledger or subsidiary loan ledgers to the general ledger.
4. Obtain the branch's internal listing of Shared National Credits and verify ratings with regulatory records.
5. Review the branch's lending policies to determine:
  - a. If the policies are adequate for the size, nature, and business of the bank.
  - b. If the branch is in compliance with its policies.
  - c. If the policies are reviewed and updated periodically to ensure they are relevant with changing market conditions and new business lines of the bank.
  - d. If policies have been approved by the head office.
6. If applicable, review minutes of the branch's loan committee meetings to determine:
  - a. Current members and their attendance record.
  - b. Scope of work performed.
  - c. Any information deemed useful in the examination of specific loan categories or other areas of the branch.

## LOAN REVIEW

In general, a loan review program should provide an independent means to identify credit and loan administration weaknesses, provide accurate and timely reports to management detailing weaknesses discovered, and provide a means for recognizing potential problems.

7. Determine if the loan review program ensures independence from the lending function including whether:
  - a. Policies specifically address the separation of loan review from the lending and credit approval functions.
  - b. The loan review function reports directly to the head office, a regional office, or a senior branch officer not involved in the lending function. If not, determine if the branch has adequate controls to ensure independence from the lending function.
8. Determine if the frequency of loan review is adequate, and if the program includes:
  - a. A minimum frequency of reviews.
  - b. A frequency which is sufficient to provide timely information concerning emerging trends in the portfolio and general economic conditions.
  - c. Increased frequency for identified problem credits.
9. Evaluate the adequacy of the scope of the loan review, including:
  - a. Method of loan selection.
  - b. Manner in which loans are reviewed, including:
    - an analysis of the current financial condition of the borrower which addresses repayment ability, and
    - tests for documentation exceptions, policy exceptions, noncompliance with internal procedures, and violations of laws and regulations.
10. Assess the qualifications of the personnel involved in the credit review function.
11. Evaluate the loan review reporting system including credit file memoranda, head office reports, and an annual schedule or loan review plan, to ensure it is thorough, accurate and timely and will provide sufficient information to allow management and the head office to both identify and control risk.

Determine if the reports include:

- a. Identification of problem credits.
- b. Current information regarding portfolio risk.
- c. Information concerning emerging trends in the portfolio and the branch's lending areas.

- h. The accuracy and completeness of reports submitted to the head office or regional office.
  - i. Competency of senior management, loan officers and credit administration personnel.
15. Determine, through information previously generated, the causes of existing problems or weaknesses within the system, which present potential for future problems.

## CREDIT GRADING SYSTEM

12. Assess the adequacy of the credit grading system and determine if it:
  - a. Includes an objective grading system for loans.
  - b. Contains explicit definitions of the branch's internal grading system, and that it is easily understood by all lenders and loan review staff.
  - c. Designates who has ultimate authority to assign and change credit grades.
13. Evaluate the accuracy of the branch's credit grading system by comparing the credit grade assigned by the branch with those assigned by examiners. Determine the extent of management's knowledge of its own loan problems.

## GENERAL CREDIT RISK ADMINISTRATION

14. Assess the effectiveness of the branch's credit administration and portfolio management by evaluating:
  - a. Management's general lending philosophy in such a manner as to elicit management responses.
  - b. The volume and magnitude of differences in grades assigned by the branch and by the examiners.
  - c. The impact of credits not supported by current and complete financial information and analysis of repayment ability.
  - d. The impact of credits for which loan and collateral documentation are deficient.
  - e. The volume of loans improperly structured, e.g., repayment schedule does not match loan purpose.
  - f. The volume and nature of concentrations of credit, including concentrations of classified and criticized credits.
  - g. The appropriateness of transfers of low quality credits to or from another affiliated office.

## PROBLEM LOAN ADMINISTRATION

16. Determine if the branch has adequate policies and procedures for problem and work-out loans, including:
  - a. A periodic review of individual problem credits.
  - b. Guidelines for collecting or strengthening the loan, including requirements for updating collateral values and lien positions, documentation review, officer call reports.
  - c. Volume and trend of past due or nonaccrual credits.
  - d. Qualified officers handling problem loans.
  - e. Guidelines on proper accounting for problem loans, e.g., non-accrual policy; specific reserve policy.

## COMPLIANCE

17. Assess the branch's compliance with laws and regulations, by determining whether:
  - a. The branch has loans to affiliates (Section 23A of the Federal Reserve Act).
  - b. A bank officer or employee received anything of value for procuring or endeavoring to procure any extension of credit (18 USC 215 for Commission or Gift for Procuring a Loan).
  - c. The branch has a stated purpose for each loan over \$10 thousand, except those secured by real estate (31 CFR 103.33(a) of the Bank Secrecy Act).
  - d. The branch is in compliance with state and federal lending limits, as described in Regulation K, or specific statutes.
  - e. The branch is in compliance with Regulation O regarding loans to insiders. (applicable to FDIC-insured branches only).

18. Forward any violations of law to the examiner in charge of compliance, and include a cross reference here.

### SPECIFIC RESERVES

19. Ensure that any specific reserves reported by the branch are appropriate, i.e., based on a specific loss amount that has been identified for an individual credit.
20. Determine if the branch accounts for specific reserves appropriately when the underlying asset has been transferred, sold, or paid off.
21. Review the management reports submitted to the head office, to determine that reports are sufficiently detailed to evaluate risk factors.
22. Summarize your findings being sure to consider the following:
  - a. Check for noncompliance with internal policies, practices, procedures, and controls. Determine if instances of noncompliance are system-wide or limited to a specific area.
  - b. Organize exceptions in order of relative importance.
  - c. Organize and prepare a listing of violations of laws and regulations.
  - d. Determine the aggregate amount of loans criticized in each of the four levels of criticism.
- e. Compile a listing of all loans not supported by current and complete credit information and collateral documentation.
- f. Compile a listing of low quality loans transferred to or from another lending institution through purchases/sales, participations, or swaps.
23. Discuss results of the examination of the lending function with senior management, structuring inquiries in such a manner as to:
  - a. Elicit management responses for correction of deficiencies.
24. Write, in appropriate report format, general remarks including:
  - a. The scope of the examination of the lending function.
  - b. The quality of internal policies, practices, procedures, and controls over the lending function.
  - c. The general level of adherence to internal policies, practices, procedures, and controls.
  - d. The scope and adequacy of the internal loan review system.
  - e. The quality of the entire loan portfolio.
  - f. The competency of management with respect to the lending function.
  - g. Causes of existing problems.
  - h. Expectations for continued sound lending or correction of existing deficiencies.
25. Prepare a complete set of workpapers to support conclusions, and discuss all material findings with management.

# Credit Risk Management

## Internal Control Questionnaire

Effective date July 1997

## Section 3010.4

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

1. Has a policy for credit risk management been adopted that specifically:
  - a. Establishes suggested guidelines for distribution of loans in the commercial, real estate, and other categories?
  - b. Establishes geographic limits, including country limits, for loans?
  - c. Establishes suggested guidelines for aggregate outstanding loans in relation to other balance sheet categories?
  - d. Establishes loan authorities of committees and individual lending officers?
  - e. Defines acceptable types of loans?
  - f. Establishes maximum maturities for various types of loans?
  - g. Establishes loan pricing?
  - h. Establishes appraisal policy?
  - i. Establishes minimum financial information required at the inception of the credit?
  - j. Establishes limits and guidelines for purchasing loans?
  - k. Establishes collection procedures?
    - l. Defines the duties and responsibilities of loan officers and loan committees?
  - m. Outlines loan portfolio management objectives that acknowledge the need to employ personnel with specialized knowledge and experience?
2. Are the following reported to the head office at least monthly:
  - a. Past due loans?
  - b. Loans on nonaccrual?
  - c. Classified loans?
  - d. Loans requiring special attention?
  - e. New loans, loan renewals, and restructured loans?
3. Are reports checked by a designated individual for possible omissions before they are submitted to the head office?
4. Are written applications required for all loans?
5. Do credit files contain the following information:

### GENERAL INFORMATION

- The borrower's name, address, ownership, and affiliations?
- A description of the borrower's business?
- Amount, rate and maturity of the loan; type of loan; appropriate approvals?
- The purpose of the loan?
- The primary and secondary sources of repayment?
- The planned repayment schedule?
- The disposition of the loan proceeds?

### FINANCIAL INFORMATION

- Current financial information on the borrower and guarantor (if applicable)?
  - Three years of previous financial statements?
  - An analysis of the borrower's and guarantor's (if applicable) financial condition?
  - Projections for the borrower's future financial performance?
  - A description of the collateral, its location, value, and condition?
  - Covenant compliance checksheet, if applicable.
6. Does the branch perform a credit investigation on proposed and existing borrowers for new loan applications?
  7. Is it required that all loan commitments be in writing?
  8. Are lines of credit reviewed and updated at least annually?
  9. Are borrowers' outstanding liabilities checked to appropriate lines of credit before additional advances are granted?
  10. Does the branch employ a procedure for disclosure of a loan or combination of loans that are or will be secured by 25 percent of another insured financial institution's stock?
  11. Is there an internal review system that:
    - a. Rechecks interest, discount, and maturity date computations?
    - b. Reexamines notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?

- c. Determines that loan approvals are within the limits of the branch's lending authorities?
- d. Determines that notes bear the initial of the loan officer?
- e. Ascertains that new loans are within the limitations set for the borrower by corporate resolution?
- f. Rechecks the liability ledger to determine that new loans have been accurately posted?

Loan transfers, purchases and sales involving other U.S. branches and affiliates of the FBO are evaluated to determine whether branch management retains responsibility for the loan. In such a case, the management of the transferred loans will be considered in assessing risk management at the branch. Loan transfers are also evaluated to determine whether they were transferred to avoid classification and to determine any effect of the transfer on the institution's condition. In cases where the transfer is suspected of being improper, the appropriate regulatory authorities for the other financial institution involved in the transfer should be notified.

- 12. Review loan transfers for the following:
  - a. Determine that the branch does not buy back or pay interest on defaulted loans in contravention of the underlying loan agreement.
  - b. Compare the volume of loans purchased and sold to the total portfolio.
  - c. Determine that the branch has sufficient expertise to properly evaluate the volume of loans purchased and sold.
  - d. Determine if loans are sold primarily to accommodate overline needs of customers or to generate fee income.
  - e. Investigate any situations where assets were transferred before the date of the examination to determine if any were transferred to avoid possible criticism during the examination.
  - f. Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous exami-

- nation, or were considered to be of questionable quality for any other reason.
- g. Review the branch's policies and procedures to determine whether or not assets or participations purchased by the branch are given an independent, complete, and adequate credit evaluation.
- h. Determine that assets purchased by the branch are properly reflected on its books 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 by the branch at less than book value.

- 13. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?
- 14. Has the branch conducted industry studies for those industries in which it is a substantial lender?
- 15. Are loan proceeds ever disbursed in cash? If so, notify BSA examiner.
- 16. Are loans ever paid off by liquidating cash collateral? If so, notify BSA examiner.
- 17. Are adequate accounting and control procedures in effect with respect to recoveries?
- 18. Are adequate procedures in effect to monitor compliance with the lending limits?
- 19. Are original loan documents safeguarded properly?
- 20. Are notes and collateral periodically verified by an independent party?

## CONCLUSION

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

# Credit Risk Management

## Audit Guidelines

Effective date July 1997

## Section 3010.5

1. Test the additions of the trial balances and the reconciliation of the trial balances to the general ledger. Include loan commitments and other contingent liabilities.
2. Using an appropriate sampling technique, select loans from the trial balance and perform the following:
  - a. Prepare and mail confirmation forms to borrowers. Loans serviced by other institutions, either whole loans or participations, should be confirmed only with the servicing institution. Confirmation forms should include borrower's name, loan number, the original amount, interest rate, current loan balance, contingency and escrow account balance, and a brief description of the collateral.
  - b. After a reasonable time, mail second requests.
  - c. Follow up on any no-replies or exceptions, and resolve differences.
  - d. Examine notes for completeness and verify date, amount, and terms to trial balance.
  - e. In the event any notes are not held at the branch, request confirmation by the holder.
  - f. Check to see that the note is signed, appears to be genuine, and is negotiable.
  - g. Check to see that the required initials of the approving officer are on the note.
  - h. Determine that the amount is within the officer's lending limit.
  - i. Compare collateral held in files with the description on the collateral register.
  - j. Determine that the proper assignments, stock powers, hypothecation agreements, statements of purpose, etc., are on file.
  - k. Test the pricing of the negotiable collateral.
  - l. Determine that margins are reasonable and are in line with branch policy and legal requirements.
  - m. Determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.
  - n. Forward a confirmation request on any collateral held outside the branch.
  - o. For accounts receivable financing, reconcile accounts receivable invoices to collateral records.
  - p. For banker's acceptances, compare collateral (e.g. trust receipts and warehouse receipts) with the description on the collateral records. Check to be sure that procedures are in effect to preclude a customer from obtaining additional credit extensions on the same merchandise.
  - q. Review escrow account provisions to determine if undisbursed amounts are at least equal to the provisions in the escrow agreements. Determine if debit entries to escrow accounts are authorized according to the terms of the loan agreement and if they are supported by individual bills or other evidence.
  - r. List all discrepancies and investigate.
  - s. Determine that each file has documentation supporting guarantees and subordination agreements, where appropriate.
  - t. Determine that any necessary insurance coverage is adequate and that the branch is named as loss payee.
  - u. Review participation agreements, making excerpts where necessary for such items as rate of service fee, interest rate, retention of late charges, and remittance requirements, and determine whether participant has complied.
  - v. Review disbursement ledgers and authorizations and determine if authorizations are signed in accordance with the terms of the loan agreement.
3. Review the accrued interest accounts by:
  - a. Reviewing and testing procedures for accounting for accrued interest and for handling of adjustments.
  - b. Scanning accrued interest for any unusual entries and following up on any unusual items by tracing to initial and supporting records.
  - c. For those loans selected in step 2, independently calculate the amount of accrued interest and verify the amount to the detail of accrued interest receivable for that loan.
4. Using a list of nonaccruing loans, check loan accrual records to determine if interest income is not being recorded.

5. Obtain or prepare a schedule showing the monthly interest income amounts and the accounts receivable loan balance at each month-end since the last audit and:
  - a. Calculate yield.
  - b. Investigate significant fluctuations and/or trends.
6. Test accuracy and completeness of all management reports.

Asset-based lending is a specialized area of commercial lending in which borrowers assign their interests in certain accounts receivable and inventory, and in selected cases, fixed assets, to the lender as collateral. In asset-based lending, the primary repayment source is the conversion of the pledged assets into cash. Asset-based lending differs from a commercial loan in which the bank takes a security interest in all accounts receivable and inventory owned or acquired by the borrower. This section will discuss asset-based lending in relation to the characteristics of the borrower, its advantages to the borrower and the branch, credit and collateral analysis, documentation, and safeguards to ensure the authenticity and collectibility of the assigned receivables.

The examiner must judge the quality of the credit by evaluating the financial condition and debt-servicing ability of the borrower and the quality of the collateral. In addition, the examiner must evaluate the branch's internal controls, policies, practices, and procedures.

### CHARACTERISTICS OF THE BORROWER

Many borrowers whose financial condition is not strong enough to allow them to qualify for regular, secured commercial loans may use asset-based loans to meet their financial needs. Typical characteristics of asset-based borrowers are those which:

- Are growing rapidly and need year-round financing in amounts too large to justify unsecured credit or commercial lines of credit secured by blanket liens on accounts receivable and inventory;
- Are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic clean-ups;
- Have inadequate working capital for the volume of sales and type of operation; and,
- Cannot obtain regular commercial loan terms because of deteriorating credit factors.

### ADVANTAGES TO THE BORROWER AND THE BRANCH

From the borrower's viewpoint, asset-based lending:

- Provides an efficient way to finance an expanding operation because borrowing capacity expands as sales increase;
- Permits the borrower to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors on a satisfactory basis, thereby building a strong business relationship and reducing the cost of goods sold;
- Ensures a revolving, expanding line of credit for which the actual interest paid may be less than that for a fixed amount unsecured loan.

From the branch's viewpoint, asset-based lending:

- Generates a relatively high yield loan commensurate with the perceived credit risk of the borrower;
- Generates a depository relationship which provides income and enhances the branch's ability to monitor changes in the borrower's cash flow and overall financial condition;
- Permits a continuing branch relationship with longstanding customers whose financial condition no longer warrant unsecured credit or traditional commercial lines of credit; and,
- Minimizes potential loss when the loan is collateralized by a percentage of the accounts receivable and inventory.

However, as discussed further, this type of lending requires close and periodic supervision of the borrower's financial condition and regular monitoring of the borrower's accounts receivables to ensure compliance with the financing agreement.

### CREDIT AND COLLATERAL ANALYSIS

Although asset-based loans are collateralized and closely monitored, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and supports the loan, the borrower must demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort. The borrower's financial statements should be analyzed with particular emphasis on working capital and its trends. Trade reports should be

reviewed, the agings of receivables and payables should be scrutinized, and inventory turnover should be analyzed. Furthermore, the prompt payment of taxes, especially payroll taxes, should be verified. A primary reason for a company to obtain asset-based financing is to maximize discounts offered by suppliers; therefore, it should pay creditors promptly upon receiving the financing. If it is not doing so, it may be diverting the funds out of the business and/or the company's financial condition may not warrant this type of financing.

Branch management's ability to recognize a customer's financial problems as they develop and to initiate orderly liquidation, if necessary, is important in the supervision of asset-based financing. The line theoretically could be fully liquidated by discontinuing further advances, collecting the assigned receivables and liquidating pledged inventory. However, such drastic action could cause the borrower's business to close resulting in a probable deterioration of the receivables from new disputes and in returns and offsets. So that the branch's loan may be liquidated in an orderly manner without losses or other adverse effects, the branch usually notifies its borrower of a contemplated liquidation, allowing the borrower time to seek other means of continuing the business. Asset-based lines where the financial position has declined so that refinancing is prevented should be criticized, unless the branch has initiated an orderly liquidation. When such a liquidation is occurring, the examiner may not see the need for classification if the borrower's business is continuing, the existing collateral is of good quality, and no collateral deterioration is anticipated.

In asset-based lending, branch management should continually evaluate the realizable value of assets pledged. To do so, management should review the loan agreement and compliance therewith; the quality of the assets pledged, including documentation; and the safeguards to ensure the authenticity and collectibility of the pledged assets. The information obtained is sometimes difficult to interpret unless it is related to other periods, comparable businesses, or industry statistics. The following factors should be considered in evaluating the quality of assets pledged:

*The turnover of the receivables pledged and the borrower's credit limit.* If the turnover is

decreasing, the quality of receivables may be deteriorating.

*Aging of accounts receivable.* The branch should obtain a monthly aging of the accounts receivable pledged. The examiner should note the percentage of accounts delinquent in relation to the total accounts pledged, and those accounts having past due balances, which also have current amounts due.

*Concentration of debtor accounts.* A lender may be vulnerable to loss if a large percentage of the dollar amount of receivables assigned is concentrated in a few accounts. A list of concentrations should be prepared periodically showing the largest accounts.

*Ineligible receivables.* The examiner should be aware of receivables that, by their nature, should be excluded from the lending formula. The following are examples of receivables that may be considered ineligible:

- *Due from affiliated companies.* Although such receivables might be valid, the temptation for the borrower to create fraudulent invoices would be great.
- *Receivables subject to a purchase money interest, such as floor plan arrangements.* The manufacturer will frequently file financing statements when merchandise is delivered to the borrower. That filing usually gives the manufacturer a superior lien on the receivable. An alternative would be to enter into an agreement with the manufacturer where rights to the receivables are subordinated to the branch.

*Financial strength of debtor accounts.* The branch should maintain credit information and trade reports on large debtor accounts as part of the borrower's credit file. The examiner should determine whether the debtor accounts are significant to the borrower's business and are well rated and financially strong.

*Disputes, returns, and offsets.* The borrower should furnish promptly to the branch copies of all significant credit memoranda issued. An analysis of those memoranda must be made. A large or increasing volume of such transactions could adversely affect the branch's collateral position.

## DOCUMENTATION

*Loan Agreement*—An asset-based loan agreement is a contract between a borrower and the branch that sets forth conditions governing the handling of the account and the remedies available in the event of default. Among the major provisions, might be:

- A percentage advance against acceptable receivables. The advance may depend on the gross profit margin from the sale of merchandise and the credit quality of the borrower's customers. For example, if a borrower has a gross profit margin of 30 percent, the maximum advance might be 70 percent, with a reduced percentage if the borrower's customers do not have top credit ratings.
- Use of only acceptable receivables. This term refers to a branch's outlining qualifications for acceptance. For example, acceptable receivables may include only those accounts that are current or not more than a given number of days past due. The entire amount of receivables may be unacceptable if a certain percentage, e.g., 10 percent, is 90 days or more delinquent.
- A maximum dollar amount due from any one account debtor. Because there is always the possibility of unforeseen and undisclosed credit failure or a return of merchandise, a common benchmark is that no more than 20 percent of the receivables assigned are from one customer.

*Documentation of Advances*—There are two dominant methods by which advances are made. Under the *blanket assignment* method, the borrower periodically supplies the branch with documentation of the amount of receivables outstanding on its books. Based upon this information, the branch advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a non-notification basis and payments on receivables are made directly to the borrower, who then remits them to the branch. The branch applies all or a portion of such funds to the borrower's loan and/or the cash collateral account, which is under the branch's control. Under the *ledgery of accounts* method, the lender receives duplicate copies of the invoices together with the shipping documents and/or delivery receipts. Upon receipt of satisfactory information, the branch advances

the agreed percentage of the outstanding receivables. The receivables are usually pledged on a notification basis. Under this method, the branch maintains complete control of all funds paid on all accounts pledged by requiring the borrower's customer(s) to remit directly to the branch. The same application of payments is then used as under the blanket assignment method. Regardless of the methods used, the branch should ensure its collateral through a program of regular audit and direct confirmation.

*Security Agreement and Financing Statement*—Article 9 of the Uniform Commercial Code (UCC) applies to any transaction that is intended to create a security interest in accounts receivable. Under the UCC, the branch must create a valid and enforceable security interest and *perfect* that interest. Once an enforceable security interest is created, the secured party can always enforce it, on default, against the debtor, provided there is no superior third-party interest. If the holder of a valid and enforceable Article 9 interest takes the additional steps required to perfect under Article 9, it will defeat most such third parties.

Under the provisions of the UCC, a branch should request from the Secretary of State, or other filing office, a listing of any open liens on the customer's receivables or inventory. Providing no such liens are outstanding, the branch should then obtain a Security Agreement, Accounts Receivable and a Financing Statement and file promptly. The security agreement and financing statement should cover current and future accounts and advances for all proceeds thereof (a "blanket assignment"), or detail the specific item(s) being taken as collateral (a "specific assignment"). To protect its rights to the receivables, the lending branch should consider taking a lien on the borrower's current and future inventory and all proceeds thereof.

Sections 9-203 and 9-204 of the UCC require that the parties take four steps to create a valid and enforceable security interest. They must:

- Enter into a security agreement.
- Reduce as much of that agreement to writing as is necessary to satisfy Section 9-203, which also requires that the debtor sign this writing or give possession of the collateral to the creditor.
- Have the debtor acquire rights in the collateral.
- Have the secured party give value.

Section 9-302(10) provides for automatic perfection, without filing a financing statement, when any or all assignments to the branch do not transfer a significant part of the outstanding accounts of the borrower. However, in all other accounts receivable security interests, the branch must file a financing statement to perfect its security interest. The law of the jurisdiction in which the debtor is located provides where the financing statement must be filed. Filing location is determined by place of business, executive office, or residence if the debtor has no place of business in the state. Refer to the appropriate State jurisdiction for filing instructions.

The financing statement, which is the document filed for public notice, must:

- Give the names and mailing addresses of the debtor and secured party.
- Be signed by the debtor.
- Give an address of the secured party from which information concerning the security interest may be obtained.
- Give the mailing addresses of the debtor and the secured party.
- Contain a statement indicating the types of collateral or describing the items or collateral.
- Be renewed every five years.

A copy of the security agreement is sufficient as a financing statement if it meets the preceding requirements.

Although effective compliance with the UCC creates, in most instances, a valid and enforceable first lien, it does not insulate the branch from the need to police its collateral. By filing, the branch establishes the right to collect on only those receivables assigned to it, provided:

- The sales are legitimate.
- The merchandise has been delivered.
- The merchandise is as ordered.
- Sales were made without warranties (almost all sales are covered by warranties).
- The merchandise was not shipped on consignment.
- The merchandise is not subject to offset, i.e., contra accounts or liens.
- The receivable has not already been paid to the borrower.

## ENSURING AUTHENTICITY AND COLLECTIBILITY

Regardless of the advance methods used, the following safeguards, which branch management should consider and the examiner should evaluate, ensure the authenticity and collectibility of the pledged assets:

*Audits.* To verify the information supplied by the borrower to the branch, the branch sends its staff member(s) to the borrower's place of business to audit its books. The audit should occur several times a year, usually on a quarterly basis. The scope of such audit should include preparation of balance sheets, profit and loss statements, working capital analysis, agings of payables and receivables, an inspection of inventory and related records, and a determination that the debtor accounts are properly marked on the books as assigned to the branch. The audit also should include procedures to determine whether all significant credit memoranda have been properly issued and reported by the borrower to the branch.

*Confirmations.* To verify the authenticity of the pledged collateral, the branch should institute a program of direct confirmation. This procedure is particularly important if the accounts receivable are pledged on a non-notification basis because the branch does not have the same control of the debtor accounts as it does when the receivables are pledged on a notification basis. Direct confirmations should be made before the initial lending arrangement and, thereafter, at least semiannually. Confirmations should be on a positive basis. The branch should obtain written approval from the borrower before confirming accounts receivable on a non-notification basis. Further, the branch should consider using the name of a phantom company as sender of the confirmations and having the confirmations returned to a post office box to ensure that account debtors do not know that their receivables are being pledged.

# Asset-Based Lending

## Examination Objectives

Effective date July 1997

## Section 3020.2

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1. To determine if the policies, practices, procedures, and internal controls regarding asset-based lending are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for collateral sufficiency, credit quality, and collectibility.
4. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Asset-Based Lending

## Examination Procedures

Effective date July 1997

## Section 3020.3

Refer to the Credit Risk Management examination procedures for general procedures to assess the risk of asset-based lending activities. However, if the branch engages in significant asset-based lending activities, and additional information is needed, the examiner should perform the following examination procedures.

1. If selected for implementation, complete or update the Internal Control Questionnaire for this area.
2. Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
3. Review the following information for selected asset-based loans:
  - a. Relationship between amount collected in a month on the receivables pledged as collateral and the borrower's credit limit.
  - b. Aging of accounts receivable.
  - c. Ineligible receivables.
  - d. Concentration of debtor accounts.
  - e. Financial strength of debtor accounts.
  - f. Disputes, returns, and offsets.
  - g. Management's safeguards to ensure the authenticity and collectibility of the assigned receivables.
4. Analyze secondary support offered by guarantors and endorsers.
5. Ascertain compliance with established branch policy.
6. Discuss with appropriate officer(s) and prepare a summary of the branch's asset-based lending activities.
7. Evaluate the function with respect to:
  - a. The adequacy of written policies relating to asset-based lending.
  - b. The manner in which branch officers are conforming with established policy.
  - c. Adverse trends within the asset-based lending department.
  - d. Accuracy and completeness of the management reports relating to asset-based lending obtained from the branch.
  - e. Internal control deficiencies or exceptions.
  - f. Recommended corrective action when policies, practices, or procedures are deficient.
  - g. The competency of departmental management.
  - h. Other matters of significance.
8. Update the workpapers with any information that will facilitate future examinations.

# Asset-Based Lending Internal Control Questionnaire

Effective date July 1997

## Section 3020.4

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Refer to the Credit Risk Management internal control questionnaire for a general review of the branch's internal controls, policies, practices, and procedures. If the branch engages in significant asset-based lending activities, and additional information is needed, the examiner should complete the following internal control questionnaire. For audit procedures, refer to the Credit Risk Management section 3010.5.

1. Does the branch have policies specifically relating to asset-based lending that:
  - a. Establish procedures for reviewing asset-based lending applications?
  - b. Establish standards for determining credit lines?
  - c. Establish standards for determining the percentage advance to be made against acceptable receivables?
  - d. Define acceptable receivables?
  - e. Establish minimum requirements for verification of borrower's pledged assets?
  - f. Establish minimum standards for documentation?
2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

3. Does the branch record on a timely basis a first lien on the assigned receivables for each borrower?
4. Do all loans granted on the security of the receivables also have an assignment of the inventory?
5. Does the branch verify the borrower's accounts receivable or require independent verification on a periodic basis?
6. Does the branch require the borrower to provide aged accounts receivable schedules on a periodic basis?

### CONCLUSION

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

Banking organizations, including branches, have long been involved with asset-backed securities (ABS), both as investors in such securities and as major participants in the securitization process. In recent years, they have stepped up their involvement by increasing their participation in the long-established market for securities backed by residential mortgage loans. Banking organizations have also expanded their securitization activities to include other types of assets, such as credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables.

### AN OVERVIEW OF ASSET SECURITIZATION

In recent years, the number of banking organizations that have issued securities backed by their own assets and that have acquired ABS as investments has increased markedly. This increase has resulted because securitization activities can yield significant financial and operational benefits.

In its simplest form, asset securitization involves the selling of assets. The process first segregates generally illiquid assets into pools and transforms them into capital market instruments. The payment of principal and interest on these instruments depends on the cash flows from the assets in the pool underlying the new securities. The new securities may have denominations, cash flows, and other features that differ from the pooled assets making the securities in them more attractive to investors.

The federal government encourages the securitization of residential mortgages. In 1970, the Government National Mortgage Association (GNMA) created the first publicly traded mortgage-backed security. Soon, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), both government-sponsored agencies, also developed mortgage-backed securities. The guarantees provided by these government or government-sponsored entities assure investors of the payment of principal and interest and have thus greatly facilitated the securitization of mortgage assets. As previously mentioned, securities have also been issued that are backed by other assets such as: credit card receivables, automobile loans, boat loans, com-

mercial real estate loans, home equity loans, student loans, nonperforming loans, and lease receivables.

### BENEFITS AND RISKS OF ASSET SECURITIZATION

While the objectives of securitization may vary from organization to organization, there are essentially five benefits that can be derived from securitized transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an FBO's books generally reduces capital requirements and reserve requirements on the deposits funding the asset. Second, asset securitization provides originators with an additional source of funding or liquidity or both. The process of securitization basically converts an illiquid asset into a security with greater marketability. Securitized issues often require a credit enhancement, which results in a higher credit rating than what would normally be obtainable by the institution itself. Consequently, these issues may provide a cheaper form of funding to the banking organization. Third, securitization may be used to reduce interest-rate risk by improving the organization's asset-liability mix. Such a benefit is more likely if the organization has a large investment in fixed-rate, low-yield assets. Fourth, by removing assets, the organization enhances its return on equity and assets. Finally, the ability to sell these securities worldwide diversifies the organization's funding base which reduces the dependence of the branch on local economies.

It may be appropriate for a banking organization, including a branch, to engage in securitization activities and to invest in ABS, if it does so in a prudent manner. Nonetheless, these activities can significantly affect a branch's overall risk exposure. It is of great importance, particularly given the growth and expansion of such activities, that examiners be fully informed of the fundamentals of the securitization process, including knowledge of the various risks that securitization and investing in ABS create for branches. Additionally, examiners need to be aware of the pertinent examination procedures in order to effectively assess the branch's exposure to risk and its ability to manage that exposure.

The following instructions were developed for Federal Reserve System use in order to provide examiners with the information and guidance they need on asset securitization. These instructions discuss the mechanics of securitization and related accounting issues while also providing a set of examination guidelines, objectives, and procedures.<sup>1</sup> The various state and federal agencies may differ in terms of specific practices and methodologies used to implement these guidelines. For further guidance in this area, examiners should consult with their respective agencies.

## THE SECURITIZATION PROCESS

The asset securitization process begins with the segregation of loans or leases into pools that are relatively homogeneous with respect to credit, maturity, and interest-rate risks. These pools of assets are then transferred to a trust or other entity known as an issuer, because it issues the securities or ownership interests that are acquired by investors. These asset-backed securities may take the form of debt, certificates of beneficial ownership, or other instruments. The issuer is typically protected from bankruptcy by various structural and legal arrangements. A sponsor that provides the assets to be securitized owns or otherwise establishes the issuer.

Each issue of ABS has a servicer that is responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing them). A trustee is responsible for monitoring the activities of the servicer to ensure that it properly fulfills its role.

A guarantor may also be involved to ensure that principal and interest payments will be received by investors on a timely basis, even if the servicer does not collect these payments from the obligors. Many issues of mortgage-backed securities are guaranteed directly by GNMA, a government agency backed by the full faith and credit of the U.S. government, or by FNMA or FHLMC, both government-

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1. The Federal Reserve System has developed a three-volume set that contains educational material concerning the process of asset securitization and examination guidelines. The volumes are as follows: (a) An Introduction to Asset Securitization, (b) Accounting Issues Relating to Asset Securitization, and (c) Examination Guidelines for Asset Securitization.

sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued, mortgage-backed securities and other types of asset-backed securities generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from a portion of or all credit losses. Usually, the amount of the credit enhancement is based upon several multiples of the historical losses experienced on the particular asset backing the security.

## Credit Enhancement

One form of credit enhancement is the recourse provision, or guarantee, that requires the originator to cover any losses up to an amount contractually agreed upon. Some asset-backed securities, such as those backed by credit card receivables, typically use a spread account. This account is actually an escrow account. The funds in this account are derived from a portion of the spread between the interest earned on the assets in the underlying pool and the lower interest paid on securities issued by the trust. The amounts that accumulate in the account are used to cover credit losses in the underlying asset pool up to several multiples of historical losses on the particular asset collateralizing the securities.

Overcollateralization, another form of credit enhancement covering a predetermined amount of potential credit losses, occurs when the value of the underlying assets exceeds the face value of the securities. A third form of credit enhancement involves the use of the senior-subordinated security structure. Under such a structure, at least two classes of asset-backed securities are issued, with the senior class having a priority claim on the cash flows from the underlying pool of assets. Therefore, the subordinated class must absorb credit losses before they can be charged to the senior portion. Because the senior class has this priority claim, cash flows from the underlying pool of assets must first satisfy the requirements of the senior class. Only after these requirements have been met will the cash flows be directed to service the subordinated class.

A more recent form of credit enhancement is the cash collateral account, which is established when a third party deposits cash into a pledged account. The use of cash collateral accounts

grew as the number of highly rated banks and other credit enhancers declined in the early 1990s. Other forms of credit enhancement include standby letters of credit, pool insurance, or surety bonds from third parties.

An investment banking firm or other organization generally serves as an underwriter for ABS. In addition, for asset-backed issues that are publicly offered, a credit rating agency will analyze the policies and operations of the originator and servicer as well as the structure, underlying pool of assets, expected cash flows, and other attributes of such securities. Before assigning a rating to the issue, the rating agency will also assess the extent of loss protection provided to investors by the credit enhancements associated with the issue.

Traditional lending activities are generally funded by deposits or other liabilities with both the assets and related liabilities reflected on the balance sheet. Liabilities must generally increase in order to fund additional loans. In contrast, the securitization process generally does not increase on-balance-sheet liabilities in proportion to the volume of loans or other assets securitized. As discussed more fully below, when banking organizations securitize their assets and these transactions are treated as sales, both the assets and the related ABS (i.e., liabilities) are removed from the balance sheet. The cash proceeds from the securitization transactions are generally used to originate or acquire additional loans or other assets for securitization and the process is repeated. Thus, for the same volume of loan originations, securitization results in lower assets and liabilities in comparison to traditional lending activities.

## The Structure Of Different Types Of ABS

Asset securitization involves different types of capital market instruments. These instruments may be structured as *pass-throughs* or *pay-throughs*. Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis. This type of security may be a single-class instrument such as a GNMA pass-through or a multi-class instrument such as a real estate mortgage investment conduit (REMIC).<sup>2</sup>

2. In the early 1980s, collateralized mortgage obligations

The pay-through structure with multiple classes combines the cash flows from the underlying pool of assets and reallocates them to two or more issues of securities that have different cash flow characteristics and maturities. An example is the collateralized mortgage obligation (CMO), which has a series of bond classes, each with its own specified coupon and stated maturity. In most cases, the assets that make up the CMO collateral pools are pass-through securities. Scheduled principal payments, and any prepayments, from the underlying collateral go first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows are used to retire the later bond classes. The development of the pay-through structure resulted from the desire to broaden the marketability of these securities to investors who were interested in maturities other than those generally associated with pass-through securities.

Multiple-class, ABS may also be issued as derivative instruments, such as stripped securities. Investors in each class of a stripped security will receive a different portion of the principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as interest-only (IO) strips, for which the investor receives 100 percent of the interest from the underlying pool of assets and as principal-only (PO) strips, for which the investor receives all of the principal.

In addition to these securities, other types of financial instruments may arise as a result of asset securitization, as follows:

- *Loan servicing rights*—these instruments are created when organizations purchase or originate loans, sell or securitize the loans, and retain the right to act as servicers for pools of loans. The cost of these purchased servicing rights may be recorded as an intangible asset when certain criteria are met. In addition, servicing rights are created when organizations

(CMOs), or multiple class securities, were introduced to help minimize the reinvestment and interest rate risks inherent in the traditional fixed rate mortgage-backed security. As a result of the Tax Reform Act of 1986, REMIC was created. The REMIC is a more flexible mortgage security, which expanded the appeal of the CMO structure to a wider investor base and offered preferred tax status to both investors and issuers. Today, almost all CMOs are issued in REMIC form. (From The ABCs of CMOs, REMICs and IO/POs: Rocket Science Comes to Mortgage Finance, Journal of Accountancy, April 1991, p. 41.)

purchase the right to act as servicers for loan pools.

- *Excess servicing fee receivables* —These instruments generally arise when the present value of any additional cash flows from the underlying assets that a servicer expects to receive exceeds standard servicing fees.
- *ABS residuals (sometimes referred to as residuals or residual interests)*—They represent claims on any cash flows that remain after all obligations to investors and any related expenses have been met. Such excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

## SUPERVISORY CONSIDERATIONS

Clear benefits can accrue to banking organizations that engage in securitization activities and invest in ABS. Nonetheless, securitization activities can increase the overall risk profile of the banking organization if the activities are not carried out in a prudent manner. For the most part, the types of risks that financial institutions encounter in the securitization process are identical to those that they face in traditional lending transactions. These involve credit risk, concentration risk, interest-rate risk, including prepayment risk, operational risk, liquidity risk, moral recourse risk, and funding risk. However, because the securitization process separates the traditional lending function into several limited roles such as originator, servicer, credit enhancer, trustee, and investor, the types of risks that a branch will encounter will differ depending on the role it assumes.

As with direct investments in the underlying assets, investors in ABS will be exposed to credit risk, that is, the risk that obligors will default on principal and interest payments. Investors are also subject to the risk that the various parties, for example, the servicer or trustee, in the securitization structure will be unable to fulfill their contractual obligations. Moreover, investors may be susceptible to concentrations of risks across various ABS issues through over-exposure to an organization performing various roles in the securitization process, or as a result of geographic concentrations within the pool of assets providing the cash flows for an individual issue. Also, because the

secondary markets for certain ABS are thin, investors may encounter greater than anticipated difficulties when seeking to sell their securities. Furthermore, certain derivative instruments, such as stripped ABS and residuals, may be extremely sensitive to interest rates and exhibit a high degree of price volatility, and, therefore, may dramatically affect the risk exposure of investors, unless used in a properly structured hedging strategy.

## Issuer

Banking organizations that issue ABS may be subject to pressures to sell only their best assets, thus reducing the quality of their own loan portfolios. On the other hand, some organizations may feel pressures to relax their credit standards because they can sell assets with higher risk than they would normally want to retain for their own portfolios.

To protect their names in the market, issuers may feel pressures to provide moral recourse by repurchasing securities backed by loans or leases that they originated and which have since deteriorated and become nonperforming. Funding risk may also be a problem for issuers when market aberrations do not permit the issuance of ABS that are in the securitization pipeline.

## Servicer

Banking organizations that service securitization issues must ensure that their policies, operations, and systems will not permit breakdowns that may lead to defaults. Substantial fee income can be realized by acting as servicer. An institution already has a fixed investment in its servicing systems, and achieving economies of scale relating to that investment is in its best interest. The danger, though, lies in overloading the systems' capacity, thereby creating enormous out-of-balance positions and cost overruns. Servicing problems may potentially precipitate a technical default, which, in turn, could lead to the premature redemption of the security. In addition, expected collection costs could exceed fee income. (For further guidance, refer to the Federal Reserve's *Commercial Bank Examination Manual*, Loan Portfolio Management section.)

## Accounting Issues

Asset securitization transactions are frequently structured to obtain certain accounting treatments, which, in turn, affect reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for ABS, a key question is whether the transfer should be treated as a sale of the assets or as a collateralized borrowing, that is, a financing transaction secured by assets. Sales treatment results in the assets being removed from the branch's balance sheet, thus reducing total assets relative to earnings and capital and, thereby, producing higher performance and capital ratios. Treatment of these transactions as financings, however, means that the assets in the pool remain on the balance sheet and the related liabilities are subject to reserve requirements.<sup>3</sup>

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3. Note, however, that it is the Federal Reserve's Regulation D that defines what constitutes a reservable liability of a depository institution. Thus, although a given transaction may qualify as an asset sale for regulatory reporting purposes, it nevertheless could result in a reservable liability under Regulation D.

## Securitization Of Commercial Paper

Over time, banking institutions have increasingly been involved in the securitization of commercial paper. It is important to note, however, that asset-backed commercial paper programs differ from other methods of securitization. One difference is that more than one type of asset may be included in the receivables pool. Moreover, in certain cases, the cash flow from the receivables pool may not necessarily match the payments to investors because the maturity of the underlying asset pool does not always parallel the maturity of the structure of the commercial paper. Consequently, when the paper matures, it is usually rolled over or funded by another issue. In certain circumstances, a maturing issue of commercial paper cannot be rolled over. To address this problem, many banking institutions have established back-up liquidity facilities. Certain banking institutions have classified these back-up facilities as pure liquidity facilities despite the credit-enhancement element present in such facilities and, as a result, have incorrectly assessed the risks associated with such back-up liquidity facilities. In these cases, the back-up liquidity facilities have been more similar to direct credit substitutes than to loan commitments.

# Asset Securitization

## Examination Objectives

Effective date July 1997

## Section 3030.2

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1. To determine if the branch is in compliance with laws, regulations and policy statements.
2. To determine if the branch is involved in originating, servicing, providing credit enhancements, serving as a trustee for, or investing in securitized assets.
3. To determine that securitization activities are properly managed within the context of the branch's overall risk management techniques.
4. To determine that management has an appropriate level of experience in securitization activities.
5. To ensure that the branch does not hold any asset-backed securities that are inappropriate, given the size of the branch and the sophistication of its operations, e.g., IOs and POs.
6. To ensure that all asset-backed securities owned and any assets sold with recourse are properly accounted for on the branch's books and in the branch's regulatory reports.
7. To determine that sources of credit risk are understood and properly analyzed and managed without excessive reliance on credit ratings by outside agencies.
8. To determine that credit, operational, and other risks are recognized and are addressed through appropriate policies, procedures, management reports, and other controls.
9. To determine if officers are operating in conformance with established branch policies and procedures.
10. To determine that liquidity and market risks are recognized and the branch is not excessively dependent on securitization as a substitute for funding or as a source of income.
11. To determine that steps have been taken to minimize the potential for conflicts of interest due to securitization.
12. To determine that possible sources of structural failure in securitization transactions are recognized, and that branch and head office management has adopted measures to minimize the impact of such failures should they occur.
13. To determine that branch and head office management is aware of the legal risks and uncertainty regarding various aspects of securitization.
14. To determine that concentrations of exposure in the underlying asset pools, in the asset-backed securities portfolio, or in the structural elements of securitization transactions are avoided.
15. To determine that all sources of risk are evaluated at the inception of each securitization activity and are monitored on an ongoing basis.
16. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations or policy statements have been noted.

# Asset Securitization Examination Procedures

Effective date July 1997

## Section 3030.3

These procedures represent a comprehensive list of processes and activities to be reviewed during a full scope examination. The examiner-in-charge will establish the general scope of the examination and work with the examination staff to tailor specific areas for review as circumstances warrant. The procedures selected will be based on internal audit comments, previous examination workpapers, a general review of the activity to be examined, and the judgement of the examiner and examiner-in-charge.

1. Request a schedule of all asset-backed securities owned by the branch. Reconcile to subsidiary ledgers of the balance sheet and review credit ratings assigned to these securities by independent rating agencies. Determine that the accounting methods and procedures used for these assets, at inception and throughout the carrying life, are appropriate.
2. Request and review information on the types and amount of assets that have been securitized by the branch. In addition, request information concerning potential contractual or contingent liability from guarantors, underwriting, and servicing of securitized assets, whether originally securitized by the branch or not.
3. Review the branch's policies and procedures to ensure that it follows prudent standards of credit assessment and approval for all securitization exposure. Procedures should include thorough and independent credit assessment of each loan or pool for which it has assumed credit risk followed by periodic credit reviews to monitor performance throughout the life of the exposure. If a branch invests in asset-backed securities, determine whether there is sole reliance upon the conclusions of external rating services when evaluating the securities.
4. Determine that rigorous credit standards are applied regardless of the role the branch plays in the securitization process, for example, servicer, credit enhancer, or investor.
5. Determine that major policies and procedures, including internal credit review and approval procedures and in-house exposure limits, are reviewed periodically and approved by head office management.
6. Determine whether adequate procedures for evaluating the branch's internal control procedures and financial strength of the other institutions involved in the securitization process are in place.
7. Obtain the documentation outlining any credit enhancements and the remedies available in the event of a default. In addition, both originators and purchasers of securitized assets should have a prospectus on the issue. Obtaining a copy of the prospectus can be an invaluable source of information; a prospectus generally should contain information on credit enhancement, default provisions, subordination agreements, etc. In addition to the prospectus, obtain the documentation confirming the purchase or sale of a security.
8. Ensure that, regardless of the role a branch plays in the securitization process, the documentation for an asset-backed security clearly specifies the limitations of the branch's legal responsibility to assume losses.
9. Verify whether the branch, acting as originator, packager, or underwriter, has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. The repurchase of defaulted assets or pools, although not required by the underlying agreement, in effect sets a standard by which a branch could potentially be found legally liable for all sold assets. Review and report any situations in which the branch has repurchased or otherwise reimbursed investors for poor quality assets.
10. Evaluate credit risk of asset-backed securities and classify any adverse credit risk. List classified assets and evaluate the impact of the classifications on the overall evaluation of the branch.
11. Aggregate securitization exposures with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor when determining compliance with internal credit exposure limits.

12. Review the branch's valuation methodology for asset-backed securities to determine if it is appropriate.
13. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio and evaluated in the context of the risk management assessment.
14. Ensure that, in addition to policies limiting direct credit exposure, a branch has developed exposure limits with respect to particular originators, credit enhancers, trustees, and servicers.
15. Review the policies of a branch engaged in underwriting with regard to situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the branch to purchase and hold unsold securities. All potential credit exposure should be within prudential lending limits.
16. Ensure that internal systems and controls adequately track the performance and condition of internal exposures and monitor the branch's compliance with internal procedures and limits. In addition, verify that adequate audit trails and internal audit coverage are in place. Ensure that the internal reports are adequate in scope and frequency.
17. Determine that management information systems provide:
  - a. A listing of all securitizations in which the branch is involved.
  - b. A listing of industry and geographic concentrations.
  - c. Information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters.
  - d. Information regarding portfolio aging and performance relative to expectations.
  - e. Periodic and timely information to head office management on the branch's involvement in, and credit exposure arising from, securitization.
18. Check whether internal auditors review all facets of securitization on a regularly basis.
19. Review policies and procedures for compliance with applicable state and federal lending limits. These requirements must be analyzed to determine whether a particular asset-backed security issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation, if they are issued or guaranteed by an agency or instrumentality of the U.S. government.
20. Determine whether the underwriting of asset-backed securities of affiliates are:
  - a. Rated by an unaffiliated, nationally recognized statistical rating organization.
  - b. Issued or guaranteed by FNMA, FHLMC, or GNMA, or represent interests in such obligations.
21. Determine if purchases of high-risk mortgage-backed securities were made to reduce the overall interest rate risk of the branch. Determine if the branch evaluates and documents at least quarterly whether these securities have reduced its interest rate risk.
22. Review and discuss any documentation exceptions, violations, internal control exceptions, and classifications with management and obtain and document management's response.
23. Review the branch's liquidity agreements with any asset-backed commercial paper programs and determine whether the agreements have any credit related components. Is the branch required to purchase the assets? Are these assets repurchased from the branch? If the facility is determined to be a commitment, determine whether its maturity is short-term or long-term. Do any of the liquidity agreements contain a material adverse clause or any other credit contingency provision?

# Asset Securitization

## Internal Controls Questionnaire

Effective date July 1997

## Section 3030.4

Review the branch's internal controls, policies, practices, and procedures for all aspects of asset securitization. The branch's system should be documented in a complete and concise manner and should include, *where appropriate*, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

### POLICIES

1. Does the branch employ the services of a securities dealer? If so, does the branch rely solely on the advice of such a dealer when purchasing asset-backed securities for the branch's investment portfolio? Does the branch have staff responsible for reviewing and approving the investment manager's acquisitions? Have minimum criteria been established for selecting a securities dealer?
2. To ensure a proper level of supervision over branch activities, has head office management reviewed and ratified asset securitization policies, practices, and procedures that:
  - a. Require an initial thorough and independent credit assessment of each asset pool for which the branch has assumed credit risk as either a participant in the securitization process or as an investor?
  - b. Address the repurchase of assets and other forms of reimbursement to investors by the branch when it is serving as the originator, packager, or underwriter in the event that a default results in losses exceeding any contractual credit enhancement?
  - c. Ensure that the credit, pricing, and servicing standards for securitized assets are equivalent to standards for assets that remain on the branch's books?
  - d. Ensure that the credit, pricing, and servicing standards and compliance with any provisions relating to government guarantees are reviewed periodically by head office management?
  - e. Establish in-house diversification requirements, within proper risk management techniques, regarding aggregate outstanding exposures to a particular institution, industry, or geographic area?

- f. Hedge the branch's exposure to adverse price movements when engaged in underwriting or market-making activities?
3. Are securitization policies reviewed and reaffirmed at least annually to determine if they are compatible with changing market conditions?

### INTERNAL CONTROL/MANAGEMENT INFORMATION SYSTEMS

4. Do the branch's internal systems and controls adequately track the performance and condition of internal exposures, and do the systems monitor the branch's compliance with internal procedures and limits? Are adequate audit trails and internal and external audit coverage provided?
5. Do the branch's cost accounting systems provide a reliable determination of the profitability and volatility of asset securitization activities?
6. Are management information systems and reporting procedures adequate, in that they:
  - a. Provide a listing of all securitizations for which the branch is originator, servicer, credit enhancer, underwriter, or trustee?
  - b. Provide a listing of industry and geographic concentrations?
  - c. Provide information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters?
  - d. Provide information regarding portfolio aging and performance relative to expectations?
  - e. Provide periodic and timely information to head office management on the branch's involvement in, and credit exposure arising from, securitization?
  - f. Provide credit ratings assigned by independent rating agencies to all asset-backed securities held by the branch?

### CONCLUSION

7. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.

8. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

# Banker's Acceptances

Effective date July 1997

## Section 3040.1

One method of financing international trade is by the use of a banker's acceptance. Such an instrument may be used to finance all of the successive stages of the movement of goods through the channels of trade from the point of origin to the final destination.

A banker's acceptance is an order in the form of a time draft (also referred to as a bill of exchange or a usance draft) drawn by one party (the drawer) in favor of itself or another party (the payee), addressed to (drawn on) a bank (the drawee) and accepted by that bank to pay the holder a certain sum on or before a specified date. The bank's acceptance of this order from the drawer, by stamping across the face of the draft **ACCEPTED** and dating and signing the stamp, is a formal acknowledgement of the obligation and constitutes an unconditional promise by that bank to honor the time draft at maturity. The drawee bank creating the acceptance is primarily liable for the instrument, while the payee, as first endorser, is secondarily liable for paying the holder in due course. If the drawee (acceptor) is other than a bank, the instrument is a trade acceptance, not a banker's acceptance.

Most banker's acceptances are used to finance trade transactions. Accordingly, acceptances are often created in connection with a letter of credit, although they may arise in connection with collection or open account transactions. Refer to the manual section entitled Letters of Credit. In general, acceptance credit is considered self-liquidating in that it provides the means for its own payment at maturity. Self-liquidation is accomplished because the acceptance must be based on a specific trade transaction in which goods are being shipped prior to entering the channels of trade. Therefore, satisfactory evidence should be available indicating that the draft, when created, is based on an actual shipment or storage. Furthermore, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

The payee of the acceptance may hold an acceptance until maturity, discount it with his or her bank, or sell it in the acceptance market. When a bank discounts (purchases) its own acceptance for the payee, its Customers' Liability on Acceptances (asset) and Bank's Liability

on Acceptances (liability) accounts are reduced and the discounted acceptance is recorded with other loans and discounts. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, that acceptance is rebooked as Customers' Liability on Acceptances and Bank's Liability on Acceptances outstanding and the loan and discount account is reduced. Rediscounted acceptances are not considered borrowings. The customer's liability on acceptances is reduced by a customer's prepayment or anticipation, of an acceptance outstanding. However, the bank's liability is not similarly reduced by an anticipation.

The established market for banker's acceptances in the United States is regulated by the Federal Reserve System. Federal Reserve Banks are authorized to discount or purchase eligible banker's acceptances subject to qualitative and quantitative limits, thus providing a source of liquidity to the selling banks. The creation of banker's acceptances is governed by Section 13 of the Federal Reserve Act (12 USC 372), which establishes criteria that must be met in order for the instrument to be eligible for either discount or purchase by the Federal Reserve Banks. In addition, for federally-licensed branches, the eligible banker's acceptance limit is in addition to the loan and investment securities limits. The rules governing whether an acceptance meets the eligibility requirements for discount or purchase are important for two major reasons. First, acceptances meeting the conditions of eligibility are more readily salable in the market than are acceptances that do not satisfy these conditions and, as such, provide a greater degree of liquidity for the accepting bank. Second, unlike eligible acceptances, ineligible acceptances are subject to reserve maintenance requirements, thus raising the cost to the borrower over that of an eligible acceptance. For federally-licensed branches, ineligible banker's acceptances are subject to the limits specified in 12 USC 84 and are combined with loans. The examiner must be familiar with the criteria used for determining eligibility for discount or purchase by the Federal Reserve Banks.

Branches that are subject to reserve requirements (i.e. controlled by an entity with \$1 billion in total worldwide consolidated assets) under Section 7 of the International Banking Act of 1978 (12 USC 3105(a)) are subject to the limitations described in Section 13 of the Federal

Reserve Act (12 USC 372). These regulations limit the amount of eligible banker's acceptances that may be created to 150 percent (or 200 percent with the permission of the Board) of the paid up and unimpaired capital stock and surplus of the foreign banking organization (FBO). In addition, all U.S. branches of an FBO are prohibited from creating eligible banker's acceptances for any one person in the aggregate in excess of 10 percent of the FBO's capital. Eligible banker's acceptances growing out of domestic transactions are not to exceed 50 per-

cent of the aggregate of all eligible acceptances authorized for a branch.

Banker's acceptances, as a source of finance and investment, offer significant advantages to borrowers, accepting banks, and investors alike. Over the years, a banker's acceptance has often been a cheaper financing vehicle than a loan, because it is readily marketable, is considered an important secondary reserve for the accepting bank, and is a relatively secure investment to the investor because of its two-name backing.

# Banker's Acceptances

## Examination Objectives

Effective date July 1997

## Section 3040.2

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1. To determine if objectives, policies, practices, procedures, and internal controls regarding banker's acceptances are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function as it applies to banker's acceptances.
4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
5. To determine compliance with applicable federal and state laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Banker's Acceptances

## Examination Procedures

Effective date July 1997

## Section 3040.3

1. If selected for implementation, complete or update the Internal Control Questionnaire for this section.
  2. Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
  3. Review the bankers acceptance section of the lending policy for adequacy.
  4. Check scope of internal audit to ensure that it covers a review of bankers acceptances.
  5. Reconcile balances to departmental controls and the general ledger.
  6. Verify that appropriate accounting methods are used and that regulatory reports are accurately prepared.
  7. Determine that there is appropriate segregation of duties in that:
    - a. Individuals who prepare and post BA records also do not issue official checks or handle cash,
    - b. Individuals who perform reconciliations and certifications also do not process acceptances, and
    - c. Persons who investigate exceptions and respond to inquiries do not normally process acceptances.
  8. Ensure the branch has an adequate system to track outstanding exceptions and delinquencies.
  9. Ensure that acceptances are registered in some manner (manual log book or computer system), consecutively numbered, and identified by type of transaction so as to leave an audit trail.
  10. Review procedures for safeguarding blank, accepted, and pre-signed documents and drafts.
  11. Review procedures for determining BA eligibility. Ensure that ineligible acceptances are appropriately segregated from the eligible acceptances. Ineligible acceptances cannot be discounted at the Federal Reserve and are treated as reservable liabilities.

*Eligibility can be determined by reviewing documentary evidence detailing the nature of the transaction underlying the credit extended. This evidence may be in the form of correspondence, title documents, or document transmittal letters that provide sufficient detail to judge*
- eligibility according to established criteria. Details provided should cover:*
- *Value of merchandise.*
  - *Description of merchandise.*
  - *Origin and destination of shipment.*
  - *Date of shipment.*
  - *Certification that the merchandise is not being financed elsewhere.*
12. Review procedures for financing clean acceptances (*i.e. when the title and shipping documentation is not processed by the office*) to ensure they include:
    - a. Details of the shipment such as invoice amount, type of commodity or merchandise, ports of embarkation and debarkation, and the bill of lading date.
    - b. Certification that duplicate financing does not exist.
    - c. An agreement by the customer to provide copies of invoices and bills of lading to the branch upon request.
  13. Review procedures for monitoring the stipulated aggregate liability limitations on outstanding acceptances. Systems should be in place to monitor the global customer exposure on the aggregate outstanding amount on a consolidated basis which cannot exceed 150% of parent bank capital.
  14. Select a sample of bankers acceptances created for specific borrowers and review credit files for credit risk. Forward findings to examiner in charge of loan review.
  15. Ensure the branch has procedures in place to comply with OFAC and Anti-Boycott provisions.
  16. Prepare, in appropriate format, the findings and conclusions regarding:
    - a. The adequacy of policies relating to banker's acceptances.
    - b. Whether branch officers are operating in conformance with established policy.
    - c. Adverse trends within the banker's acceptance department.
    - d. The accuracy and completeness of the schedules obtained.
    - e. Internal control deficiencies or exceptions.
    - f. Recommended corrective action when policies, practices, or procedures are deficient.

- g. Other matters of significance.
17. Update the workpapers with any information that will facilitate future examinations.

# Banker's Acceptances

## Internal Control Questionnaire

Effective date July 1997

Section 3040.4

### POLICIES

1. Have policies been adopted that:
  - a. Establish procedures for reviewing banker's acceptance applications?
  - b. Define qualified customers?
  - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

3. Is the preparation and posting of subsidiary banker's acceptance records performed or reviewed by persons who do not also handle cash or issue official checks or drafts?
4. Are the subsidiary banker's acceptance records balanced daily with the appropriate general ledger accounts and are reconciling items adequately investigated by persons who do not normally handle acceptances and post records?
5. Are acceptance delinquencies prepared for and reviewed by management on a timely basis?
6. Are inquiries about acceptance balances received and investigated by persons who do not normally handle settlements or post records?
7. Are bookkeeping adjustments checked and approved by an appropriate officer?
8. Is a daily record maintained, summarizing acceptance transactions details, i.e., banker's acceptances created, payments received, and fees collected, to support applicable general ledger account entries?
9. Are acceptances of other banks that have been purchased in the open market segregated on the branch's records from the branch's own acceptances purchased?
10. Are prepayments on banker's acceptances netted against the appropriate asset account Customer Liability for Acceptances Outstanding (or loans and discounts, depending upon whether the branch has discounted its own acceptance), and do they continue to

be shown as a liability under Bank's Liability on Acceptances Outstanding?

11. Are banker's acceptance record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record acceptance transactions?

### FEES

12. Is the preparation and posting of fees and discounts performed or reviewed by persons who do not also handle cash or issue official checks or drafts?
13. Are any independent fee and discount computations made and compared or adequately tested to initial fee and discount records by persons who do not also handle cash or issue official checks or drafts?

### OTHER

14. Are acceptance record copies, own acceptances discounted (purchased) and acceptances of other banks purchased safeguarded during banking hours, locked in the vault overnight, and periodically inventoried?
15. Are blank (pre-signed) customer drafts maintained under dual control in the vault, numbered, inventoried monthly, and verified with the customer on a monthly basis?
16. Are any acceptance fee rebates approved by an officer?
17. Does the branch have an internal review system that:
  - a. Reviews collateral and supporting documentation held for negotiability and proper assignment?
  - b. Test checks the values assigned to collateral at frequent intervals?
  - c. Determines that lending officers are periodically advised of maturing banker's acceptances or acceptance lines.
  - d. Determines that the individuals to whom funds are being disbursed are authorized by the beneficiary to receive the funds?
  - e. Addresses funding procedures for rediscounted acceptances?

- f. Tests for compliance with IBF restrictions?
18. Does the branch's acceptance filing system provide for the identification of each acceptance, e.g., by consecutive numbering and applicable letter of credit, to provide a proper audit trail?
19. Is the information covered by this internal control questionnaire adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
20. Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

## CONCLUSION

19. Is the information covered by this internal control questionnaire adequate for evaluat-