

Contingent liabilities, also referred to as off-balance-sheet items, should be analyzed as part of the branch's overall risk management assessment. Potential exposure, funding sources, the adequacy of risk management, and internal controls for off-balance-sheet risks are specific matters that should be considered.

As a regular part of their operation, some branches are involved in originating financial contracts that may result in the acquisition of certain assets and liabilities at some future date, under certain conditions. Generally accepted accounting principles do not consider these contracts in themselves to be assets or liabilities and, thus, do not recognize them on the face of the balance sheet. These off-balance-sheet items are quite diverse in nature and purpose and may include such instruments as firm loan commitments, standby letters of credit, foreign exchange, financial futures, forward contracts, options, interest rate swap contracts, and other derivative products.

Greater competition, marketing innovations, and government deregulation have changed the focus of attention from contingent liabilities. In addition to assessing the risk in off-balance-sheet *instruments*, examiners must also assess the risk of off-balance-sheet *activities*. Branches are now involved in a wide spectrum of banking activities designed to generate fee income, such as securities clearance and brokerage activities, data processing services, and investment and management advisory services. As the branches find more avenues of non-traditional banking activities available to them, they may expand the scope of services offered to customers. These new activities may involve risks which are difficult to quantify, such as legal risk.

In recent years, there has been significant growth in the volume of contingent liabilities related to various derivative products. At the same time, growth in standby letters of credit enhancements has moderated due to global risk-based capital considerations.

There are many types of risks which the examiner should be aware of: principal (position), credit, and settlement risk (i.e., loss of principal due to default by a contractual party); interest rate (basis), market, and foreign exchange risk (i.e., depreciation of principal amount or loss of income due to rate, market or currency fluctuations); daylight overdraft risk (i.e., exposure due to transactions originating and settling

during the same day); liquidity risk (i.e., lack of funds to honor commitments leading to higher borrowing costs); country risk; and litigation risk. Of these, the major risk to consider would be credit risk, interest rate risk, and market risk.

It is essential that a system of controls be in place to limit off-balance-sheet risk. These controls, including policies, procedures, recordkeeping systems, and audit coverage, should be sufficiently detailed to ensure proper performance evaluation by branch and head office management, auditors, and regulatory authorities.

Formal written policies, stating goals and strategies and setting limitations at various levels, are necessary to prevent abuses and to act as benchmarks against which performance may be gauged. A limit should be placed on an activity's total volume. In addition, limits should be established for individual customers, and parameters set for traders. Procedures should be in place to ensure that operations are consistent with written policies. Comprehensive recordkeeping and reporting are needed for adequate audit coverage and management information. Most importantly, branch management should be aware of all off-balance-sheet activity and ensure that controls and procedures are in place to identify and monitor attendant risk.

The purpose of this section is to serve as a concise reminder of the major types of off-balance-sheet items. Examination objectives, examination procedures, and internal control questionnaires for these items are found in the appropriate sections of this manual, the Federal Reserve's Trading Activities Manual, and other similar material developed by the other federal and state bank supervisory agencies. For further guidance in this area, examiners should consult with their respective agencies.

Contingent liabilities containing primarily credit risk include the following categories:

COMMITMENTS TO MAKE OR PURCHASE LOANS OR TO EXTEND CREDIT IN THE FORM OF LEASE FINANCING ARRANGEMENTS

These transactions include the portion of commitments that obligate the branch to extend credit in the form of loans (including credit card

lines), participations in loans, lease financing receivables, or similar transactions. This category would include commitments for which the branch has charged a commitment fee or other consideration or otherwise has a legally binding commitment.

STANDBY LETTERS OF CREDIT

A standby letter of credit provides for payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the issuing bank's customer) upon the presentation of a draft or documentation required in the letter of credit. A standby letter of credit, typically, is unsecured and is payable against a simple statement of default or nonperformance. Refer to this manual's section on Letters of Credit for additional information.

COMMERCIAL AND SIMILAR LETTERS OF CREDIT

A commercial documentary letter of credit is an instrument in which a bank (issuing bank) undertakes to pay a party (beneficiary) named in the instrument a sum of money on behalf of the bank's customer (account party). This type of letter of credit is used most commonly to provide a bank's credit and possible financing to a commercial contract for the shipment of goods from seller to buyer. The beneficiary will be paid when the terms of the letter of credit are met and the required supporting documents are submitted to the paying or negotiating bank. Refer to this manual's section on Letters of Credit for additional information.

PARTICIPATIONS IN ACCEPTANCES CONVEYED TO OTHERS BY THE SUBJECT BRANCH

A banker's acceptance is a time draft or bill of exchange that has been drawn on and accepted by a banking institution for payment by that institution at some future date. Participations in acceptances conveyed to others by the accepting bank include such transactions that provide for the other party to the participation to pay the

amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults.

PARTICIPATIONS IN ACCEPTANCES ACQUIRED BY THE SUBJECT BRANCH

Participations in acceptances of other banks acquired by the branch (nonaccepting bank) include such transactions that provide for the nonaccepting bank to pay the amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults.

Contingent liabilities containing interest, market, and credit risk include the following categories:

FUTURES AND FORWARD CONTRACTS

Futures and forward contracts are tools for use in asset and liability management, and can be used by branches to effectively hedge portions of their portfolios against interest rate risk. Branches that engage in futures and forward contract activities should only do so in accordance with safe and sound banking practices, with levels of activity reasonably related to the branch's business needs and capacity to fulfill its obligations under the contracts. In managing their assets and liabilities, branches should evaluate the interest rate risk exposure resulting from their overall activities to ensure that the positions they take in futures and forward contract markets will reduce their risk exposure. Policy objectives should be formulated in light of the branch's entire asset and liability mix. Definitions of futures and forward contracts are as follows:

- Futures contracts are standardized contracts traded on organized exchanges to purchase or sell a specified security, money market instrument, or other financial undertaking on a future date at a specified price. Accordingly, the credit exposure is to the exchange and is generally considered to be negligible. However, this may not be the case for exchanges in less developed countries.
- Forward contracts are over-the-counter

contracts for forward placement or delayed delivery of securities in which one party agrees to purchase and another to sell a specified security at a specified price for future delivery. Contracts specifying settlement in excess of 30 days following trade date are considered to be forward contracts. Forward contracts are not traded on organized exchanges, generally have no required margin payments, and can only be terminated by agreement of both parties to the transaction.

STANDBY CONTRACTS AND OTHER OPTION ARRANGEMENTS

Standby contracts and other option arrangements are also tools for asset and liability management which, when properly used, can reduce the risks of interest rate fluctuations. Standby contracts are optional delivery forward contracts on U.S. government and agency securities, arranged between securities dealers and customers. The buyer of a standby contract (put option) acquires, upon paying a fee, the right to sell securities to the other party at a stated price at a future time. The seller of the standby (the issuer) receives the fee and must stand ready to

buy the securities at the other party's option. Exchange trading is conducted in options specifying delivery of debt securities, money market instruments, or futures contracts specifying delivery of debt securities.

FOREIGN EXCHANGE CONTRACTS

These are contracts to exchange one currency for another as of a specified date and time at a specified rate of exchange (price). Delivery of the currency may be spot (two or less business days) or forward (more than two business days).

INTEREST RATE SWAP CONTRACTS

Interest rate swap contracts are private, over-the-counter contracts between counterparties for exchanging interest payments for a specified period based on a notional principal amount. Entities generally enter into interest rate swaps for interest rate risk management; namely, to manage the interest rate exposures arising from asset and liability positions.

Branches do not have the authority to issue guarantees or sureties, except as may be incidental or usual in carrying on their banking business. Such an instance may occur when a branch has a substantial interest in the performance of the transaction involved or has a segregated deposit sufficient to cover its total potential liability.

A branch may also guarantee or endorse notes or other obligations sold by the branch for its own account. The amount of the obligations covered by such guarantee or endorsement is to be recorded as a contingent liability on the records of the branch. Furthermore, such liabilities are included in computing the aggregate indebtedness of the branch, which may be subject to limitations imposed by any applicable law or regulation.

A common example of a guarantee is a steamship letter of guarantee. Frequently, in an international sale of goods, the merchandise arrives at the importer's (buyer's) port and the complete negotiable bills of lading are either lost or delayed in transit. In such instances, it is

customary for the importer (buyer) to obtain immediate possession of the goods by providing the shipping company with a bank guarantee, often called a steamship guarantee, which relieves the shipping company of liability resulting from release of the goods without proper or complete negotiable title documents. Usually, the guarantee relies on a counter-guarantee issued to the branch by the importer.

All types of guarantees issued are to be recorded as contingent liabilities by the branch. Usually, the party for whom the guarantee was issued will reimburse the branch should it be required to pay under the guarantee; however, in certain situations, some other designated party may reimburse the branch. That other party may be designated in the guarantee agreement with the branch or in the guarantee instrument itself. The branch may also be reimbursed from segregated deposits held, pledged collateral, or by a counter-guarantor. Letters of credit, as distinguished from guarantees, are discussed in a separate section of this manual.

Guarantees Issued

Examination Objectives

Effective date July 1997

Section 3310.2

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

Guarantees Issued

Examination Procedures

Effective date July 1997

Section 3310.3

Refer to the Credit Risk Management, Examination Procedures section of this manual for examination procedures related to the risk assessment of guarantees.

1. For guarantees issued in the selected review sample, check central liability file on borrower(s) indebted above the selected cutoff review line or borrower(s) displaying credit weakness or suspected of having additional liability in loan areas.
2. Determine compliance with any applicable laws and regulations pertaining to guarantees issued by performing the following steps:
 - a. Determine that the obligations covered by such guarantees or endorsements are shown as contingent liabilities on the records and in the reports of assets and liabilities of the branch and that such liabilities are included in computing the aggregate indebtedness of the branch.
 - b. Determine which guarantees are subject to individual loan limitations to any one customer. Combine guarantees with any other extensions of credit to the account party by the issuing branch subject to loan limitations.
3. Determine if the trial balance contains expired guarantees. If so, determine the branch's policies, practices, and procedures for disposing these guarantees.
4. Update the workpapers with any information that will facilitate future examinations.

Guarantees Issued

Internal Control Questionnaire

Effective date July 1997

Section 3310.4

Review the branch's internal controls, policies, practices, and procedures for issuing and servicing guarantees.

1. Has branch and head office management adopted written policies pertaining to guarantees issued that:
 - a. Establish procedures for reviewing guarantee applications?
 - b. Define qualified guarantee account parties?
 - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

3. Are the subsidiary guarantees issued records balanced daily with the general ledger and are reconciling items adequately investigated by persons who do not normally handle guarantees?

4. Is a daily record maintained, summarizing guarantee transaction details, i.e., guarantees issued, guarantees canceled or renewed, payment made under guarantees, and fees collected, which support ledger entries?
5. Are blank guarantee forms safeguarded during banking hours and locked in the vault overnight?
6. Are all guarantees issued recorded as contingent liabilities and assigned consecutive numbers?
7. Are all guarantees issued recorded on individual customer (account party) liability ledgers?

CONCLUSION

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

Guarantees Issued

Audit Guidelines

Effective date July 1997

Section 3310.5

1. Test the addition of trial balances and their reconciliation to the general ledger.
2. Using an appropriate sampling technique, select guarantees issued from the trial balance and:
 - a. Prepare and mail confirmation forms to account parties and beneficiaries. Guarantees serviced by other institutions, either whole guarantees or syndicate participations, should be confirmed only with the servicing institution (or lead bank). Guarantees serviced for other institutions, either whole guarantees or syndicate participations, should be confirmed with the buying institution and the account party. Confirmation forms should include account party's name, guarantee number, amount, fee charged, and a brief description of any collateral or counter-guarantee held.
 - b. After a reasonable time, mail second requests.
 - c. Follow up on any no-replies or exceptions and resolve differences.
 - d. Examine written guarantee instruments for completeness and terms, and verify amount to the trial balance.
 - e. Check to see that required initials of the approving officer are on the guarantee instrument.
 - f. Check to see that the signature on the guarantee is authorized.
 - g. Compare any collateral held with the description on the collateral register.
 - h. Determine that the proper assignments, hypothecation agreements, etc., are on file.
 - i. Test the pricing of any negotiable collateral held.
 - j. Determine that collateral margins are reasonable and in line with branch policy and legal requirements.
 - k. List all collateral discrepancies and investigate.
 1. Determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.
 - m. Forward a confirmation request on any collateral held outside the branch.
 - n. Determine that each file contains documentation supporting counter-guarantees, if applicable.
 - o. Review guarantee participation agreements for such items as fees charged the account party or remittance requirements and determine whether the account party has complied.
 - p. If the branch paid a beneficiary under its guarantee, review disbursement ledgers and authorizations to determine whether payment was effected in accordance with the terms of the guarantee agreement and whether the branch was recompensed by the account party.
3. Review fees collected accounts by:
 - a. Reviewing and testing procedures for accounting for fees collected and for handling any adjustments.
 - b. Scanning fees collected for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

Letters of credit are the most widely used instrument to finance international trade transactions. The two major types of letters of credit used are the commercial documentary letter of credit and the standby letter of credit.

COMMERCIAL DOCUMENTARY LETTERS OF CREDIT

This type of letter of credit is used most commonly to provide a bank's credit and possible financing to a commercial contract for the shipment of goods from seller to buyer. A commercial documentary letter of credit is a letter issued by a bank (issuing bank) on behalf of its customer (account party), a buyer of merchandise, to a seller (beneficiary), authorizing the seller to draw drafts up to a stipulated amount, under specified terms and undertaking to provide eventual payment for drafts drawn. The beneficiary will be paid when the terms of the letter of credit are met and the required supporting documents are submitted to the paying or negotiating bank.

The issuance and negotiation by banks of letters of credit are governed by Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits published by the International Chamber of Commerce. All letters of credit must be issued

- In favor of a definite beneficiary.
- For a specific amount of money.
- In a form clearly stating how payment to the beneficiary is to be made and under what conditions.
- With a definite expiration date.

Commercial letters of credit are issued in either irrevocable or revocable form. An irrevocable letter of credit cannot be changed without the agreement of all parties. Conversely, a revocable letter of credit can be canceled or amended by the issuing bank at any time, without notice to or the agreement of the beneficiary.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay, provided the beneficiary complies with the letter's terms and conditions. In contrast, the revocable credit is not truly a bank credit but serves as a device that provides the buyer and seller a

means of settling payments. Because a revocable credit can be canceled or changed without notice, the beneficiary should not rely on the credit, but rather on the willingness and ability of the buyer to meet the terms of the underlying contract.

The letter of credit may be sent to the beneficiary directly by the issuing bank or through the beneficiary's bank or through the issuing bank's correspondent located in the same place as the beneficiary. The correspondent may act as an "advising bank" that is, it may act as an agent of the issuing bank in forwarding the letter on to the beneficiary without any commitment to pay on its part. Advised letters of credit will bear a notation by the advising bank that it makes "no engagement" or words to that effect. An irrevocable advised letter of credit is, therefore, an undertaking to pay by the issuing bank but not by the advising bank.

Some beneficiaries (sellers), particularly those not familiar with the issuing bank, request that the buyer have the issuing bank ask the advising bank to add its "confirmation" to the issuing bank's irrevocable letter of credit. Confirmed letters of credit are evidenced by the confirming bank's notation: "We undertake that all drafts drawn . . . will be honored by us" or similar words. The beneficiary of a confirmed credit has a definite commitment to pay from a bank in his or her country and does not need to be concerned with the willingness or ability of the issuing bank to pay. One bank may play more than one role. For example, an advising bank may add its confirmation and be designated in the letter as the paying bank.

Payment terms of a letter of credit usually vary from sight to 180 days, although other terms sometimes are used. The letter will specify on which bank drafts are to be drawn. If the draft is drawn at sight, the bank will effect payment upon presentation of the draft provided the terms of the credit have been met. If the draft is a time draft, the drawee bank can accept the draft (by stamping "Accepted" on the face of the draft), which then can be held by either the seller or the seller's bank or the accepting bank until maturity. Alternatively, the accepted draft can be sold or discounted. (Refer to the Bankers' Acceptances section.)

Certain categories of commercial letters of credit, such as "back-to-back", "transferable", "deferred payment", "revolving", and "red

clause” credits, contain specific elements of risk. Although these types of credits are infrequently seen, branches should exercise caution in their issuance and/or negotiation.

A *back-to-back* letter of credit is one where a commercial letter of credit (master credit) is used as security to support the issuance of a second credit to another supplier (seller). The beneficiary (seller) of the credit becomes the applicant of the second letter of credit. In other words, the beneficiary assumes the role of a middleman between the actual supplier and the ultimate buyer of the merchandise. The difference between the master credit amount and the back-to-back credit is the middleman’s profit. Bank-to-back credits are most frequently seen in situations where the exporter (middleman) is unable to purchase merchandise on his own credit rating.

A *transferable* letter of credit enables the original beneficiary to transfer the rights of payment to one or more beneficiaries. These credits are normally seen when the original beneficiary acts as an agent and does not supply some or all of the merchandise or does not have the financial resources or credit necessary to purchase the merchandise. In some instances, the beneficiary may wish to keep the supplier and applicant ignorant of each other (so as to protect his profit as middleman) by requesting the advising bank to substitute his own name for that of the applicant. The rights in a transferable letter of credit may not be transferred by the second beneficiary to a third party unless otherwise stated.

Deferred payment letters of credit are similar to a commercial letter of credit in that they provide for payment at some date after shipment of the goods. However, this type of credit does not require a time draft to be presented for payment. The merchandise is released without payment. Instead, the issuing bank undertakes to reimburse the paying bank at some future date as stipulated in the credit. Deferred payment credits are discouraged by banks since no debt instrument exists to discount. The obligation represents a direct liability of the bank and is booked in a manner similar to the liability booked for an acceptance.

A *revolving* letter of credit allows for the amount of the credit to be renewed or automati-

cally reinstated without specific amendments to the credit. Such credits allow for flexibility in commercial dealings between exporters and importers; however, credits of this type usually specify a maximum overall amount which can be drawn for control purposes. Credits of this type can revolve in relation to time or value, and be cumulative or non-cumulative. In practice, the vast majority of letters of credit are non-revolving. Since the maximum exposure under an irrevocable revolving credit can be large, most revolving credits are issued in revocable form.

Originally the clause in the letter of credit was written in red ink to draw attention to the special nature of the credit. Hence, the name *Red Clause Credits*. The use of this clause permits the beneficiary to obtain an advance or pre-shipment advances from the advising or confirming bank. Its purpose is to provide the seller credit. Any advances are the responsibility of the issuing bank. Interest is normally charged by the bank making the advance until documents are presented and the bank is reimbursed by the issuing bank.

Documentation is of paramount importance in all letter of credit transactions. The branch is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Ultimate repayment often depends upon the eventual sale of the goods involved. Thus, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

STANDBY LETTERS OF CREDIT

A standby letter of credit provides for payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the issuing bank’s customer) upon the presentation of a draft or the documentation, as required in the letter of credit. Although a standby letter of credit may arise from a commercial transaction, it usually is not linked directly to the shipment of goods from seller to buyer. It may cover performance of a construction contract, serve as an assurance to a bank that the seller will honor his or her obligations under warranties, or relate to the payment of a purely monetary obligation, for example, when

the credit is used in backing payment of commercial paper.

Under all letters of credit, the banker expects the account party to be financially able to meet his or her commitments. A banker's payment under a commercial letter of credit for the customer's account is usually reimbursed immediately by the customer and does not become a loan. However, payment under a standby letter of credit generally occurs because the account party has defaulted on its primary obligation. That default can be a result of the customer being unable to pay or of a dispute between the beneficiary and the account party.

A standby letter of credit transaction involves greater potential risk for the issuing bank than does a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit retains nothing of value to protect against loss, whereas a commercial documentary letter of credit may provide the bank with title to the goods being shipped. To reduce the risk of a standby letter of credit, the issuing bank's credit analysis of the account party should be equivalent to that applicable to a borrower in an ordinary loan situation. For reporting purposes, standby letters of credit are shown as contingent liabilities in the branch's Report of Assets and Liabilities. Depending on any applicable state and federal laws and regulations, standby letters of credit may be subject to prudential limitations.

GOVERNMENT AND AGENCY GUARANTEED LETTERS OF CREDIT

The process of foreign trade also is facilitated by various U.S. government agencies and international organizations. Some programs guarantee payments under letters of credit issued by commercial banks under programs to promote U.S. exports or at the request of international organizations which reimburse banks for letters of credit issued on their behalf. The most common government agencies include the following:

The Export-Import Bank of the United States (Eximbank) is an independent agency of the U.S. government which facilitates the financing of U.S. exports through guarantying debt obligations acquired from U.S. exporters or through direct lending activities.

Private Export Funding Corporation (PEFCO) is a private corporation, incorporated in 1970, for the purpose of making U.S. dollar loans to foreign importers to finance purchases of goods or services of U.S. manufacture or origin. All loans made by PEFCO are unconditionally guaranteed by Eximbank.

Commodity Credit Corporation (CCC) is a U.S. government agency which provides commercial credit and political risk guarantees to facilitate the financing of U.S. commodity exports such as wheat and corn.

Agency for International Development (AID) is the largest unit of the International Development Co-operation Agency, administers most of the bilateral foreign aid programs of the U.S. government. AID provides U.S. dollars through loans and grants for foreign assistance recipients to purchase, principally from the U.S., products needed in connection with development programs and related technical and professional services.

International Bank for Reconstruction and Development (IBRD) is a transnational organization organized for the purpose of financing infrastructure and development projects in lesser developed countries.

Inter-American Development Bank (IADB), the oldest and largest regional multilateral development institution, was established in 1959 to help accelerate social and economic development projects in Latin America and the Caribbean.

Overseas Private Investment Corporation (OPIC) is a self-sustaining U.S. government corporation whose principal purpose is to promote economic growth in developing nations by encouraging U.S. private investment in those countries. OPIC promotes its objectives principally by insuring U.S. investors against political risks and financing selected investment projects through direct loans or loan guarantees.

ANTI-BOYCOTT REGULATIONS

The Export Administration Act of 1973 prohibits banks from taking or knowingly agreeing to take actions that support any boycott against a country friendly to the United States. Under

anti-boycott regulations (which are issued by the Department of Commerce and enforced by the Office of Anti-Boycott Compliance), U.S. banks are required to report letters of credit they receive that include illegal boycott terms or conditions and should establish an ongoing program to review all letters of credit. These regulations apply to both domestic and overseas branches of all U.S. banks.

The anti-boycott provisions prohibit banks from opening, negotiating, confirming, or paying international letters of credit that contain illegal terms or conditions. The improper language is most often seen in documentary letters of credit, sight reimbursements, and pass-on letters of credit, but may also appear in drafts and wire payments. Often, a bank's customer

may try to add improper language orally rather than in writing. Boycott language includes clauses or requirements such as:

- Certification that the goods are not of a particular origin, such as Israeli or South African;
- Certification that any supplier or provider of services does not appear on the Arab blacklist;
- The condition, "Do not negotiate with black-listed banks", or words to that effect;
- A request not to ship goods on a Israeli carrier or on a vessel or carrier that calls at Israel en route to a boycotting country; and
- A request for a certificate stating the origin or the goods or the destination of the goods.

Letters of Credit

Examination Objectives

Effective date July 1997

Section 3320.2

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

Letters of Credit

Examination Procedures

Effective date July 1997

Section 3320.3

1. Analyze the following specific types of letters of credit (when applicable) to determine if:
 - a. For Red Clause Letters of Credit (Packing Credits):
 - Clean advance or anticipatory drawing finance to the beneficiary (exporter or agent) is authorized under the letter of credit.
 - The beneficiary undertakes to deliver within the expiration date the shipping documents called for in the letter of credit.
 - The foreign bank makes advances to the beneficiary and is paid by drawing its own draft on the opening bank or the beneficiary is authorized to draw its draft on the issuing bank and the drafts received charged to the importer.
 - b. For Back-to-Back Letters of Credit:
 - The backing letter of credit is properly assigned as collateral to the bank issuing the letter of credit.
 - The terms of the letter of credit issued are identical to the backing credit except that:
 - The beneficiary and account party are different.
 - The amount may be less but not more than the backing credit.
 - The expiration date is reduced by sufficient time to allow completion of the transaction before the backing letter of credit expires.
 - The beneficiary of the backing letter of credit is a regular customer of the branch opening the second letter of credit.
 - c. For Standby Letters of Credit:
 - They represent undertakings to pay up to a specific amount upon presentation of a draft(s) and/or documents before a specified date.
 - They represent obligations to a beneficiary on part of the issuer to:
 - Repay money borrowed by or advanced to or for the account party.
 - Make payment on account of any indebtedness undertaken by the account party. Make payment on account of default by the account party in the performance of an obligation, e.g., default on loans, performance of contracts, or relating to maritime liens.
 - d. For Deferred Payment Letters of Credit (trade-related):
 - The letter of credit calls for drawing of sight drafts with the provision that such drafts are not to be paid until a specified period after presentation and surrender of shipping documents to the branch.
 - The branch's liability for outstanding letters of credit calling for deferred payment is reflected as contingent liability until such documents presented under the letter of credit are honored.
 - The branch has received, approved, and acknowledged receipt of the documents thereby becoming directly liable to pay the beneficiary at a determinable future date(s).
 - Payment will be made to the beneficiary in a specified number of months or quarterly, semiannually, annually, or beyond. (If the branch has advanced money to the beneficiary against the deferred payment letter of credit, with its proceeds assigned as collateral to repay the advance, the transaction should be treated as a loan rather than a deferred payment letter of credit).
 - e. For Clean Deferred Payment Letters of Credit:
 - Such deferred payment credits call for future payment against simple receipt without documents evidencing an underlying trade transaction.
 - Such letters of credit are shown as direct liabilities on the branch's records when drafts are presented by the beneficiary and received by the branch.
 - f. For Authority To Purchase:
 - The authority to purchase is with recourse to the drawer, without recourse to the drawer, or without recourse to the drawer but confirmed by the negotiating bank.
 - g. For Agency for International Development (AID) Letters of Credit:
 - The branch or foreign banking organization (FBO) has an AID letter of commitment authorizing the transaction.

- The branch has checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the AID commitment.
 - A letter of agreement between the branch or FBO and the foreign government exists whereby the branch or FBO has recourse should AID fail to reimburse the branch or FBO.
- h. For Commodity Credit Corporation (CCC) Letters of Credit:
- The branch or FBO has a CCC letter of commitment authorizing the branch or FBO under examination to issue letters of credit to beneficiaries supplying eligible commodities to foreign importers.
 - In instances where the branch has issued standby letters of credit in favor of the CCC, the following requirement has been met:
 - At least 10 percent of the financed amount is confirmed, i.e., guaranteed by a U.S. bank for commercial credit risk. The total value of the credit is advised through a U.S. bank.
- i. For the Export-Import Bank of the United States:
- The branch or FBO has an agency agreement from Eximbank stating:
 - Eximbank has entered into a line of credit with a foreign borrower.
 - The amount of the line.
 - The branch or FBO has been designated to issue the letter of credit(s).
 - Any payments made under an Eximbank approved letter of credit will be reimbursed by Eximbank.
 - The branch has checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the Eximbank agreement.
- j. For Advised (Notified) Letters of Credit:
- The branch is only advising the beneficiary without responsibility on its part.
- (A spot check should be made of these credits to ensure that the branch has not committed to an engagement under the letters of credit.)
- k. For Other Types of Letters of Credit:
- Any of the following U.S. government agencies and international organizations reimburse the branch for issuing letters of credit on their behalf:
 - International Bank for Reconstruction and Development (IBRD).
 - Inter-American Development Bank (IADB).
 - Overseas Private Investment Corporation (OPIC).
2. Determine that the amount of standby letters of credit does not exceed the prudential limitations on loans imposed by any applicable state and federal law (including limitations to any one customer or on aggregate extensions of credit).
- a. Combine standby letters of credit with any other nonaccepted loans to the account party by the issuing branch for the purpose of applying any state and federal loan limitations to any one customer.
- b. A standby letter of credit is not subject to loan limitations imposed by applicable law in the following instances:
- Prior to or at the time of issuance of the credit, the issuing branch is paid an amount equal to the branch's maximum liability under the standby letter of credit.
 - Prior to or at the time of issuance, the branch has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the branch's maximum liability under the standby letter of credit.
3. Determine that the credit standing of the account party under any standby letter of credit is the subject of credit analysis equivalent to that applicable to a potential borrower in an ordinary loan situation.

POLICIES

1. Has branch and head office management adopted written letter of credit policies that:
 - a. Establish procedures for reviewing letter of credit applications?
 - b. Define qualified customers?
 - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
 - d. Establish procedures to ensure that letters of credit are issued and confirmed under approved credit lines?
2. Are letter of credit policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

3. Is the preparation and posting of subsidiary letter of credit records performed or reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
4. Are the subsidiary letter of credit records (control totals) balanced daily with the appropriate general ledger accounts, and are reconciling items adequately investigated by persons who do not normally handle letters of credit and post records?
5. Are delinquencies arising from the nonpayment of instruments relating to letters of credit prepared for and reviewed by management on a timely basis?
6. Are inquiries regarding letter of credit balances received and investigated by persons who do not normally process documents, handle settlements, or post records?
7. Are bookkeeping adjustments checked and approved by an appropriate officer?
8. Is a daily record maintained that summarizes letter of credit transaction details, i.e., letters of credit issued, payments received, and commissions and fees collected, to support applicable general ledger account entries?
9. Are letter of credit record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by

employees who do not process or record letter of credit transactions?

COMMISSIONS

10. Is the preparation and posting of commissions (fees) performed or reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
11. Are any independent commission computations made and compared or adequately tested to initial commission records by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?

DOCUMENTATION

12. Are the terms, dates, weights, description of merchandise, etc. shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences with those detailed in the letters of credit instruments? Has the branch developed procedures, such as a document checklist, to ensure that all documents required by the letter of credit are presented?
13. Are procedures in effect to determine if:
 - a. The above documents are signed when required?
 - b. All discrepancies have been resolved with the agreement of all parties.
 - c. All copies of letters of credit are initialed by the officer who signed the original letter of credit?
 - d. All amendments to letters of credit are approved by an officer?

DEFERRED PAYMENT LETTERS OF CREDIT

14. Are deferred payment letters of credit:
 - a. Recorded as direct assets and liabilities of the branch after it approves and agrees to honor the beneficiaries' documents for payment?

- b. Included in “other assets” and “other liabilities” in the call report?

STANDBY LETTERS OF CREDIT

15. Are standby letters of credit segregated or readily identifiable from other types of letters of credit and/or guarantees?

OTHER

16. Are outstanding letter of credit record copies and unissued forms safeguarded during banking hours and secured in the vault overnight?
17. Are advised letters of credit recorded as memoranda accounts, separate from letters of credit issued or confirmed by the branch?
18. Are letters of credit that have been issued with reliance upon a bank, whether on behalf of, at the request of, or under an agency agreement with the bank, recorded as contingent liabilities under the name of that bank?
19. Are any commission rebates approved by an officer?
20. Does the branch have an internal review system that:
- Reexamines collateral items for negotiability and proper assignment?
 - Test check values assigned to collateral when the letter of credit is issued or

confirmed and at frequent intervals thereafter?

- Determines that customer payments of letters of credit issued are promptly posted?
 - Determines all delinquencies arising from the nonpayment of instruments relating to letters of credit?
 - Ensures expired letters of credit are closed according to branch policy generally 15 to 30 days after expiration.
21. Are all letters of credit recorded and assigned consecutive numbers?
22. Are lending officers frequently informed of maturing letters of credit and letter of credit lines?
23. Is documentation stored in a fireproof vault?
24. Are procedures in place for positive identification of the beneficiary prior to release of funds to ensure that the true beneficiary receives the funds?

CONCLUSION

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

Letters of Credit

Audit Guidelines

Effective date July 1997

Section 3320.5

1. Test the addition of the trial balances and the reconciliation of the trial balances to the general ledger.
2. Review the commission accounts relating to issuing, amending, confirming, and negotiating letters of credit by:
 - a. Reviewing and testing procedures for accounting for commissions and the handling of adjustments.
 - b. Scanning commissions for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.
3. Review all unpaid letters of credit and ascertain that management has sound policies and procedures for resolving disputes.

Trading activities include the purchase or sale of a wide range of financial instruments for speculative or hedging purposes. The range of trading instruments has experienced substantial growth in recent years. The most common instruments seen at branches include derivative products, foreign exchange, and securities. To conduct a thorough review of a trading operation, the Federal Reserve Trading Activities Manual ("TAM") should be used as a primary reference. However, the TAM is very detailed, and is applicable primarily to the most active and complex trading operations. The TAM is divided into two sections. The first section of the TAM discusses different types of trading risk plus specific detail on examination objectives, procedures, and internal control questionnaires for the core areas of any trading operation. The second section describes financial instruments that are essential to the examiner's understanding and successful implementation of a trading activities examination. These guidelines should be tailored by the examiner based on the size and sophistication of the branch and information from recent audits and examinations with input from the examiner-in-charge.

The objective of examining the trading function is to ensure that management has adequate systems to identify and measure the risks of the activities, and has taken appropriate measures to manage the risk. The systems established by management should be commensurate with the risks taken. Additionally, it is important to determine whether risk exposures are excessive relative to the branch's risk profile.

The following information is intended to provide general guidelines for reviewing a small, noncomplex trading operation, where only a few types of instruments are being traded. The general approach is to evaluate the office's policies, procedures, limits, and the content and accuracy of management information reports. In addition, operational controls are reviewed to ensure that adequate segregation of duties exist between the traders and the back office.

POLICIES, PROCEDURES AND LIMITS

Management's objective(s) for the trading function and the method used to establish strategies

should be clear. The objective(s) will usually fit into one or more of the following categories: speculation, hedging, providing a service to customers, or facilitating other business transactions.

Trading policies should be reviewed and should contain, at a minimum, the following:

- A list of approved trading products and approved brokers;
- Authorization for every trader to conduct trades;
- Reporting lines for trading and back office staff;
- Guidelines for the frequency of preparing management reports;
- Guidelines for calculating open positions;
- Procedures for estimating the risk inherent in open positions;
- Position limits and stop-loss limits for each product and each trader; and,
- Procedures for obtaining approval to trade a new product.

If traders have exceeded the limits established in the policies, determine whether traders and management took appropriate action, and whether details of the instance(s) were documented and communicated to senior management.

Traders' prior experience and the level of ongoing training should be reviewed for adequacy. The traders' journals should be reviewed to determine whether profit and loss and open positions agree with official internal records, activities conducted are consistent with the strategy and objectives stated by management, transactions are accurately reported, and unauthorized transactions are being conducted.

MANAGEMENT INFORMATION REPORTS

Management reports should contain sufficient information to provide management with an adequate level of understanding of the branch's trading activities. Reports should detail trader positions, daily revaluation of open positions, interest sensitive gaps, and profit and loss. The accuracy of management reports should be tested using subsidiary records to recalculate figures. Reported figures for open positions should also

be compared to limits established in the policies. Generally, reports for open positions and interest sensitivity should be prepared daily, and those for profit and loss and revaluations should be prepared at least weekly. At a minimum, the frequency of reports should be consistent with limits. For example, if the policy establishes an intra-day open position limit, the profit and loss should be calculated several times during the day.

OPERATIONAL CONTROLS

Examiners must evaluate the effectiveness of established operational controls within the trading function. These controls should cover segregation of duties, systems for reconciling trading positions, profits and losses, and value at risk; and should establish a system for settling trade transactions. In addition, internal audits of the office's trading activities should be conducted regularly.

Segregation of duties will ensure that instances of fraud or embezzlement, or violations of regulations are minimized. There is a clear need to separate trading personnel from control of receipts, disbursements and custody functions. Persons executing transactions should not confirm, reconcile, revalue, or clear transactions or control the disbursement of funds, securities or other payments. Persons initiating transactions should not confirm trades, revalue positions, approve or make general ledger entries, or resolve disputed trades.

Reconciliations should be performed on a timely basis. Persons performing reconciliations should be independent of the person responsible for the input of transaction data. In addition, segregation must occur between persons reconciling and persons confirming transactions. Any discrepancies should be brought immediately to

the attention of the appropriate operations manager.

Examiners should review the various methods of settlement or the range of products traded, and any exceptions to commonly accepted practices should be noted. Unsettled items should be monitored closely by the branch. Settlement risk should be controlled through the continuous monitoring of movement of the branch's money and securities and by the establishment of counterparty limits.

Internal audits of the branch's trading activities should be conducted regularly. The frequency of internal audits will depend upon the complexity and level of activity of the branch's trading operations. The scope of the audits should include a review of trading risk management. Procedures for following up on audit exceptions should be adequate. The examiner should review the internal audit reports to determine the severity of deficiencies identified, and should determine whether management implemented corrective action in a timely manner.

Generally, the head trader has regular meetings with senior management. If minutes of these meetings are maintained, the minutes should be reviewed to determine the following:

- management was adequately informed of the risks taken;
- circumstances when traders exceeded limits were reported to management;
- management was informed when market conditions were unfavorable to existing positions;
- any improper activities or defalcation were disclosed; and information in the minutes is accurate.

If minutes are not maintained, or meetings are not held, the examiner should recommend the branch do so if the amount of activity warrants such a practice.