The analysis of financial factors should be conducted in four primary parts, namely: (1) parent only, (2) banking subsidiary(ies), (3) nonbank subsidiary(ies), and (4) consolidated organization. In view of the fact that all BHCs are not structured in the same organizational and financial manner, it is important that examiners be flexible in their approach and be judicious in their use of ratio analysis and peer group comparisons. There is no substitute for using sound judgment and creativity while performing an analysis, providing all of the pertinent information is available. The summary and conclusions should follow from the information presented in the analysis.

The analysis is intended to determine the financial strengths and weaknesses of an organization and the impact of conditions at the parent company and nonbank subsidiary which could adversely affect the condition of the banking subsidiary. As a regulatory agency, a goal of the Federal Reserve System is to safeguard and protect the soundness of commercial banks. The System oversees holding company banking and nonbanking activities to assure the continued safety and soundness of individual banks and the industry as a whole.

The analysis of financial factors resulting from the inspection of a bank holding company is essentially a finding of facts and an expression of judgment. In conducting an appraisal of a holding company's condition, the financial analysis of the organization, based on a ''building block'' or ''component'' approach, should provide the examiner with a solid foundation from which to proceed. In order to complete the analysis it is first necessary to accumulate sufficient information concerning the parent company, bank and nonbanking subsidiary(ies) and the consolidated organization. A final analysis should not be attempted until these integral parts have been thoroughly reviewed.

4010.0.1 INTRODUCTION AND SCOPE OF THE ANALYSIS

The cash flow analysis is *applicable to all bank holding companies with consolidated assets in excess of $1 billion, those that have substantive fixed charges or debt outstanding,* as well as select others at the option of the Reserve Bank. Key parts of the analysis involve the use of:

1. A standardized "Cash Flow Statement (Parent)" page (refer to manual sections 5010.23 and 5020.13 for the illustrated pages) which includes computation of the cash earnings coverage ratios and analyses; regarding the results;
2. Earnings cash flow coverage ratios to measure the parent company's ability:
   a. To pay its fixed charges, including interest costs, lease expense, income taxes, retirement of long-term debt (including sinking fund provisions), and preferred stock cash dividends, and
   b. To pay common stock cash dividends.
3. Guidelines for supervisory determination of parent company debt servicing capacity.

The cash flow statement page of the inspection report presents the cash earnings and the cash expenditures of the parent company. Within the statement are the key components to be used in the "Fixed Charge Coverage Ratio," which measures the parent company's ability to meet its fixed obligations, and a "Common Stock Cash Dividend Coverage Ratio" which measures the ability of the remaining, or residual, earnings to cover common stock dividends.

4010.0.2 CASH FLOW STATEMENT

The cash flow statement is an effective tool used in understanding how a particular bank holding company operates. Its primary objective is to summarize the financing and investing activities of the holding company, including the extent to which the entity has generated funds (externally and internally) during the period. The cash flow statement is related to both the income statement and the balance sheet and provides information that otherwise can be obtained only partially by interpreting each of those statements.

An analysis of past cash flow statements can supply important information regarding the uses of funds, such as internal asset growth or acquisitions, as well as data on the sources of funds used and the financing needs of management. A projected cash flow statement will focus on the need for future funds, its applications, and the sources from which they are likely to be available.

Specifically, the analysis of the cash flow statement is necessary for a thorough understanding of a bank holding company and the nature of its operations to the extent that it provides information on such areas as:

1. Utilization of funds provided by operations;
2. Use of funds from a new debt issue or sale of stock;
3. Source of funds used for acquisitions or additional capital contributions;
4. Means of payment of a dividend in the face of an operating loss;
5. Means of debt repayment and stock redemption.

While the cash flow statement provides an overall perspective of a holding company's utilization of available funds, it does not, by itself, indicate possible or actual difficulties the parent company may have in meeting its fixed obligations from internally generated funds. Fixed obligations or fixed charges are those recurring expenses which must be paid as they fall due, which includes interest expense, lease expense, sinking fund requirements, scheduled debt repayments and preferred dividends.

One ratio that may be used to calculate the strength of a parent company's earnings to meet its fixed charges or obligations is the *Fixed Charge Coverage Ratio* (FCCR). The components of the ratio are included on the "Cash Flow Statement (Parent)" page. The Fixed Charge Coverage Ratio (FCCR) measures the parent company's ability to pay for *fixed* contractual obligations if management is to *retain control of the organization,* thereby satisfying the expectation of creditors and preferred stockholders. Net income *after taxes* is used in the formula. Interest and lease expenses are already deducted to arrive at the net income figure and must be added back to obtain the earnings available to pay such charges. Interest expense is usually the largest component among all "fixed charges," and the ability to pay this expense from earnings cash flow is critical to an assurance of continued refunding of the parent company's debt. It measures not only the extent to which net cash operating earnings covers the debt servicing requirements of the parent company, but the capacity to pay income taxes and preferred stock cash dividends as well, thereby meeting the

expectations that creditors and preferred shareholders have for the protection of their respective interests. The need for *better than a 1:1* coverage is therefore critical.

Another important formula, required to be calculated is the *Common Stock Cash Dividend Coverage Ratio* (CSCDCR) which measures the ability of the parent company to pay common stock cash dividends. The CSCDCR will show, in turn, whether the residual cash earnings of the parent company are sufficient to pay the common stock cash dividend and, if not, the amount that must be provided from other sources of cash, such as the liquidation of assets or additional borrowings, to cover the shortfall.

Significant shortfalls in the CSCDCR are to be scrutinized in light of the Board's November 1985 Policy Statement on "Cash Dividends Not Fully Covered by Earnings." According to the statement, a bank holding company should not maintain its existing rate of cash dividends on common stock unless:

1. The holding company's net income available to common stockholders over the past year has been sufficient to fully fund the dividends; *and*

2. The prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

A bank holding company whose cash dividends are inconsistent with the above criteria is to give serious consideration to cutting or eliminating its dividends. The need for *at least a 1:1 coverage* is therefore critical.

The two ratios[1] are calculated as follows:

$$\text{FCCR} = \frac{\text{After tax cash income (1) + interest expense (2) + lease \& rental expense (3)}}{\text{interest expense (2) + lease \& rental expense (3) + contractual long-term debt retired (4) + preferred stock dividend payments (5)}}$$

$$\text{CSCDCR} = \frac{\text{After tax cash income (1) − [Contractual long-term debt retired (4) + preferred stock dividend payments (5)]}}{\text{Common Stock Dividend Payments (6)}}$$

Note that the Cash Flow Statement (Parent) page presents only cash items included in the parent's income and therefore the analyst can use its income figures without any need to adjust for noncash items.

Both the Fixed Charge Coverage and the Common Stock Cash Dividends Coverage ratios are considered inadequate at less than 1:1. If a holding company is generating funds which provide at least dollar-for-dollar coverage, no criticism need be made. However, the examiner should be aware that these ratios, as well as others, are merely guidelines and good judgment must prevail. A ratio of 1.02:1 may pass the test, but it is only barely adequate. No criticism may necessarily be warranted for the period covered by the 1.02:1 ratio, but it may be indicative of a deteriorating trend over the past few years. Accordingly, an appropriate comment concerning the trend may be warranted.

When reviewing these ratios, it should be kept in mind that certain components in the numerator can to some degree be altered at the discretion of management. For example, by altering the dividends paid by bank subsidiaries, the amount of funds available to the parent to cover fixed charges can be increased or decreased. For this reason, the fixed charge and funds flow ratios should be analyzed in conjunction with a review of the dividend payout ratios of the subsidiary banks. Cash flow ratios that otherwise appear adequate may be a cause for concern if the banks are paying out dividends that are too high in relation to capital or overall condition. Analysts should evaluate the bank dividend payout ratios in light of the bank's capital and financial condition. Only in this way can the analyst gain a better understanding of the quality of the parent's cash flow and its potential effect on bank subsidiaries.

Ratios of less than 1:1 coverage show that internally generated funds are not sufficient to meet a parent company's needs. In many cases, the examiner may find low coverage ratios yet all fixed charges were paid as agreed. Had they not been, the company would have incurred severe financial difficulties long before the start of the inspection. Therefore, when less than adequate ratios appear and obligations are paid

1. The numbered ( ) items correspond to the numbered lines on the "Cash Flow Statement (Parent)" page.

on time, the examiner must determine what other source of funds was utilized to make up the shortfall and to permit the timely payment of obligations.

4010.0.3 SUPERVISORY DETERMINATION AS TO ADEQUACY OF PARENT COMPANY CASH FLOW

A supervisory determination about the adequacy of parent company cash flow, and its use as a measure of parent company debt servicing capacity, requires more information than just the results of the Fixed Charge Coverage and Common Stock Cash Dividend Coverage Ratios. The typical major parent company does not generate an earnings cash flow by conducting banking operations itself, although it nevertheless may incur a heavy external debt on behalf of its operating subsidiaries which are the generators of the actual earnings cash flow. Therefore, the parent company earnings cash flow may not be indicative of the *actual* earnings power of the entire banking organization. For example, the cash earnings of the parent company may be kept low by management to avoid State or local income tax liability and/or to increase leveraged lending volumes at the subsidiary level. Conversely, cash earnings may be forced to the parent company through imprudent levels of upstream cash dividend payments which eventually will endanger the operating subsidiaries and the parent itself.

A supervisory determination about the adequacy of parent company cash flow must take place at *two levels:* (1) by analyzing the results of the two coverage ratios using the net earnings cash flow *realized* by the parent company, *and* (2) by analyzing the effect that upstream cash flow to the parent company has had, and can be expected to have, on the financial condition of the bank subsidiaries and the significant nonbank subsidiaries. The latter focus should be on significant nonbank subsidiaries whose capital and dividend policies are subject to separate regulation—such as thrifts—or subsidiaries with significant external funding, whose creditors presumably monitor capital and dividend policies of the subsidiary.

4010.0.4 SPECIFIC GUIDELINES FOR DEBT SERVICING CAPACITY

The specific guidelines for debt servicing capacity are as follows:

1. The adequacy or inadequacy of parent company cash flow, and thereby the capacity to sustain the parent company's debt, is determined ultimately from the results of the Fixed Charge and Common Stock Cash Dividend Coverage Ratios, and the related analysis of the effects of upstream cash flow on the financial condition of the key subsidiaries.

2. For those parent companies with material amounts of long-term debt, coverage ratios in excess of 1:1 will not necessarily be considered sufficient to sustain the parent company's leverage *unless: first,* the Tier 1 capital positions of the bank subsidiaries are considered adequate; *second,* that the bank holding company's consolidated Tier 1 capital position is considered adequate; and *third,* the parent's liquidity is judged adequate. If that is not the case, then a critical comment on the ''Examiner's Comments'' page should be made regarding the potentially excessive leverage of the parent, as well as that of its subsidiaries. A specific period of time should be established for the management of the bank holding company to submit a capital improvement program acceptable to the System. *Moreover,* where the capital positions, bank and consolidated, are considered adequate but the dividend payout ratios are excessive, it is indicative of a potential future debt servicing problem and should be brought to management's attention. Since the earnings level may not be sustainable, corrective action must be taken within a specified period of time.

3. For coverage ratios of less than 1:1, there is a presumption of a critical comment on the ''Examiner's Comments'' page of the inspection report *unless* the shortfall is prudently planned,[2] insignificant in amount and/or the trend of earnings cash flow and dividend policies clearly point toward a return to sufficient parent company earnings cash flow coverage.

a. In circumstances where the Tier 1 capital position of *any bank subsidiary* is considered inadequate, a written program of corrective action should be required, including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

b. In circumstances where the Tier 1 *consolidated* capital position of the holding company is considered inadequate, a written program of corrective action should be required,

2. A planned cash flow shortfall might typically occur when the parent elects to reduce (or not increase) dividends from subsidiaries because it anticipated an excess cash or liquid asset position from certain *external sources* (i.e., stock or debt issuance, dividend reinvestment plans, or tax refunds) sufficient to cover the deficiency.

including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

c. In circumstances where the Tier 1 capital position of *each bank subsidiary* and the consolidated Tier 1 capital position of the bank holding company is considered adequate, but there is a developed trend of inadequate earnings cash flow coverage at the parent company level or excessive dividend payouts from the subsidiaries, a written program of corrective action should be required to reestablish and maintain a positive earnings cash flow at the parent company.

4010.0.5 SOURCES OF FUNDS TO MAKE UP SHORTFALLS

Basically, there are three source categories, other than current earnings, that could be used to make up any deficit: (1) liquidation of assets, (2) proceeds from a stock offering, or (3) borrowed funds. These sources must be thoroughly analyzed to determine the extent they were and could still be utilized. It must be kept in mind that the use of these sources cannot permanently eliminate a shortfall in the flow of funds from current operations. These alternative sources only alleviate temporarily the effects of a shortfall. Nevertheless, a deficit could have been intentionally allowed to occur because the holding company knew of funds coming from these alternate sources. For example, the parent knew of an impending stock sale and cut dividends from subsidiaries significantly. In future years, dividends from subsidiaries could be restored to normal proportions, bringing the ratios up to adequate levels.

At this point, it must be determined what, if any, criticism is necessary when an unplanned shortfall is made up by any of these alternate sources. The necessity of liquidating assets to meet cash needs may warrant a critical comment. The parent's advances to subsidiaries and its investment in marketable securities are considered temporary investments. That is, the holding company may reasonably expect to sell its securities and be repaid on its advances to subsidiaries within a reasonably short period of time. In the case of advances to a problem subsidiary, repayments may not be forthcoming. Nevertheless, if the parent does receive partial payments, such funds are available to meet cash needs. The concern to the examiner is the extent to which such temporary investments can be relied upon before they are fully exhausted. If the continued liquidation of those investments to meet cash needs has fully exhausted the assets or will do so in the near future, then appropriate critical comments are warranted. Such comments should stress that the liquidation of the investment portfolio and the advances to subsidiaries can no longer be considered a reliable source of funds.

Another method which may be used by a holding company to overcome a flow of funds deficiency is the sale of capital stock which is an effective source for generating permanent funds for the parent. However, it must be recognized that the primary reason for the stock offering was something other than covering the shortfall (i.e., debt repayment, capital contributions to subsidiaries, acquisitions). Therefore, it cannot be relied upon as a consistent annual source to supplement internally generated funds from operations. Also, it should be realized that the sale of stock will increase future funding requirements as additional dividends will have to be paid. Consequently, where no significant improvement in internal operations is contemplated in future periods, an appropriate comment is warranted indicating the potential problem.

Holding companies also compensate for inadequate funds flow with borrowed money. Although not a permanent source of funds, long-term debt is a source similar to the sale of stock. Its main purpose, however, was not to cover the shortfall. Long-term debt cannot be considered as a reliable, consistent annual source, and moreover, its existence creates new funding requirements.

Short-term debt is perhaps the most commonly used source to cover a deficit cash flow from operations and its use is of serious concern from a supervisory viewpoint. Unlike long-term debt and equity issues, short-term borrowings (i.e., bank loans, commercial paper) are readily available to holding companies which can and do rely on this source year after year for support. As a consequence, this indebtedness increases fixed charges and where material improvement in earnings does not develop, the shortfall could increase in subsequent periods thereby necessitating even larger borrowing requirements. This practice may jeopardize the parent's liquidity position since short-term liabilities rise without a corresponding increase in liquid assets as the borrowed funds are used to pay expenses. Here, an appropriate comment is warranted indicating the problems.

4010.0.6 REPORTING THE RESULTS

If the coverage ratios are less than 1:1, then appropriate comments are necessary to explain the external source utilized to make up the shortfall. The supporting details may be shown within the comments section of the Cash Flow Statement. More significant comments should be included on the ''Analysis of Financial Factors'' page or the ''Examiner's Comments'' page. The examiner may include prior years' results for comparative purposes.

4010.0.7 INSPECTION OBJECTIVES

1. To determine the ability of the parent to manage its cash position and operate within debt service and funding requirements.
2. To measure the parent's ability to meet its fixed obligations and its dependency on borrowed funds to meet its cash needs.
3. To determine if the parent company's dividends to stockholders are covered by residual cash earnings.
4. To analyze any cash flow transaction which may adversely affect the financial stability of the parent.
5. To discuss with parent company management:

a. Deficit cash flows arising from internal operations;

b. Steps management has taken, or plans to take, to restore adequate cash earnings coverage for fixed charges and dividend payments and whether such plans should be commensurate with the maintenance of adequate loan loss reserves and Tier 1 capital levels in the bank and major nonbank subsidiaries.

c. Any parent company borrowings or restructurings needed to sustain dividend payments to shareholders; and

d. The need to increase cash flow although there may be no deficit in current cash flow coverage.

4010.0.8 INSPECTION PROCEDURES

1. Prepare the ''Cash Flow Statement (Parent)'' FR 1225.

a. Analyze each item of the parent company's comparative balance sheet and income statement. Since accrual figures may be used for all accounts except tax and dividend payments, adjustment to the figures may be necessary for the difference between accrual and cash basis accounting.

b. Examine the underlying nature of period increases or decreases for the balances listed on the financial statements, particularly any material transactions that aided in averting coverage ratio shortfalls.

c. Note contractual long-term debt retired (net decrease in borrowed funds, including sinking fund provisions) as a memo item on the bottom of the page, where indicated.

d. Compute the fixed charge and common stock cash dividend coverage ratios as illustrated on the page. *The numbered items in the formula correspond with the numbered items on the ''Cash Flow Statement (Parent)'' page.*

e. Answer the six questions on the ''Cash Flow Statement (Parent)'' page that prompt an analysis.

2. Analyze the Results.

a. If there is full coverage, no problem should be assumed. However, *the underlying assets and transactions that provided for the coverage should be examined to make certain that ''no problem'' does, in fact, exist.*

b. If a shortfall exists, provide guidelines to the parent company's management for developing a workable contingency plan, using your ''good examiner judgement'', considering the viability of all sources in resolving the shortfall.

- Review the *sources* for making up shortfalls:
  - — Liquidation or sale of assets, *giving full consideration to external market concerns and losses that may result from the sales.*
  - — Proceeds from stock offerings.
  - — Increase in borrowed funds, including a restructuring of short term debt to long term debt.
  - — Sale of capital stock.
  - — Payments from subsidiaries on advances in the form of amortization or interest.
  - — Short term debt.

3. Report the Results.

a. *When an ''engineered'' (planned) shortfall exists,* indicate that one does exist, the reasons therefore, and the degree of severity to which it should be addressed, either as part of the answers to the questions on the ''Cash Flow Statement (Parent)'', the ''Analysis of Financial Factors'' page, or the ''Examiner's Comments'' page. Provide management's assessment as to

whether planned short falls will occur in the future.

b. When an *unplanned shortfall exists,* determine the extent of criticism that is to be made when short falls are lessened or corrected by an imprudent use of *alternative sources.* Based on the severity of the situation, determine whether the comments will be provided in the inspection report as answers to the questions on the Cash Flow Statement, or within the content of the "Analysis of Financial Factors" page, or the "Examiner's Comments" page.

BHC financial leverage is the use of debt to supplement the equity in a company's capital structure. It is anticipated that funds generated through borrowings will be invested and earn a rate of return above their cost so that the net interest margin generated will improve the company's net income, providing a higher rate of return on stockholders' equity which has otherwise remained constant. Since no creditor or lender would be willing to extend credit without the cushion and safety provided by the stockholders' equity, this borrowing process is also referred to as "trading on equity." That is, utilizing the existence of a given amount of equity capital as a borrowing base. Stockholders and management often view leveraging as a favorable financial alternative because if owners have provided only a small portion of total financing, much of the financial risk will be borne by the lenders, alleviating the need of the stockholders to assume the total risk. In addition, by raising funds through long-term debt, the owners gain the benefits of maintaining control of the firm with a limited investment rather than diluting existing ownership via the sale of additional capital stock.

There are, however, some unfavorable aspects in this type of financing. As a holding company substitutes debt for equity, keeping its asset size constant, its leverage ratio will increase. The increase in leverage increases the probability that a company may go into default since a larger portion of the income stream generated by earning assets must then be used to meet increased fixed charges (interest expense). (This assumes that increases in future earnings are not anticipated. While earnings may be sufficient to meet fixed interest expenses at the time the debt is issued, it is possible that future earnings will not be sufficient to meet the increased expenses.) In addition, utilization of leverage reduces management flexibility in making future decisions because lenders impose restrictive covenants that may limit future debt issues, limit dividend payments, or impose constraints on specific operating ratios. However, not all of the effects of increased leverage are unfavorable. Additional long-term debt may have the favorable effect of extending maturities on obligations and may improve liquidity.

Leverage ratios measure the contribution of owners compared with the financing provided by lenders. Companies with low leverage ratios generally have less exposure to loss when the economy is in a recession, but they may also have lower expected returns when the economy booms. Firms with high leverage ratios run the risk of large losses but also have a chance of earning high rates of return on equity and assets. Thus, if a company earns more on the borrowed funds than it pays in interest, the return to the owners is increased. For example, if the company earns 10 percent on assets and debt costs 8 percent, there is a 2 percent differential accruing to the stockholders. However, if the return on assets falls to 7 percent, the differential between that figure and the cost of debt must be made up from total profits.

A bank holding company is composed of at least two tiers, parent and subsidiary, and each tier may issue long-term debt in its own name. Several different types of long-term debt instruments are utilized by holding companies. Corporations make use of instruments such as debentures, convertible debentures, term loans, capital notes and mortgage notes. (See Manual section 2080.0—"Funding"). While most issues are generally sold to the public, in some cases, issues of subsidiaries have been placed directly with another subsidiary, the parent company, or perhaps with an unaffiliated banking institution. Alternatively, issues presently held on the books of the parent may have been originally issued by one of the subsidiaries and later transferred to the parent. These transfers have often occurred at the time of the formation of the holding company when debt of the subsidiaries was assumed by the parent.

The proceeds of parent company long-term debt may be advanced to banking subsidiaries as debt or invested in banking subsidiaries as equity. When parent debt is issued, and the proceeds are advanced to subsidiaries as debt, a condition of "***simple leverage***" exists. When such proceeds are invested in subsidiaries as equity, a condition of "***double leverage***" is said to exist since the increase in the subsidiary bank's capital base will allow the bank to increase its own borrowings.[1] In effect, the

1. Parent company "***total leverage***" may be defined as the relationship between equity at the parent level and the total assets of the parent company. Such assets typically consist of investments in bank and nonbank subsidiaries, advances to affiliates, deposits with bank affiliates and securities. A useful related measure of parent company leverage is "***investment leverage***" which may be defined as the relationship between parent equity and its equity investments in subsidiaries. Since the equity which has been invested in subsidiaries can, and often is, further leveraged by external borrowings of such subsidiaries, this type of parent company investment leverage

parent's capital injection which was funded by debt, provides the bank with greater debt capacity, thereby allowing the bank to borrow additional funds on its own. Therefore, the original borrowing by the parent has, in effect, been compounded when the bank borrows based on its newly injected equity.

If the parent debt is reinvested as equity in a bank, the servicing of interest and principal is usually provided by dividends paid to the parent by the bank subsidiaries. The bank dividends, however, may become restricted based on the bank's earning power which may not provide for sufficient retention of earnings to support its asset growth. Problems may be less severe when parent debt is downstreamed as debt to the bank subsidiary. When the terms and maturities of the indentures match, the obligation of a bank to meet its interest and principal payments to the parent are contractual and represent fixed charges (interest is tax deductible) which will continue up to the maturity of the note. When funds are downstreamed as equity and the bank typically issues dividends to its parent, it is easier to restrict the flow of funds from the bank than if the funds were downstreamed as debt which results in bank payments of interest expense. Bank dividend declarations are subject to limitations imposed by sections 5199(b) (12 U.S.C. 60) and 5204 (12 U.S.C. 56) of the United States Revised Statutes, while interest payments are not subject to such restrictions.

4010.1.1 ACQUISITION DEBT

Some holding companies use debt for the acquisition of subsidiary banks. The Board believes that a high level of acquisition debt can impair the holding company's ability to act as a source of strength to its bank subsidiaries, and thus does not favor the use of a substantial amount of acquisition debt in bank holding company formations. However, the Board recognizes that the use of acquisition debt in the formation of certain holding companies may be necessary, particularly when transferring the ownership of small community banks (approximately $150 million or less), and the maintenance of local ownership in those banks. To this end, and in the interest of maintaining a safe and sound banking system, the Board has adopted a policy for assessing financial factors in the formation of small one-bank holding companies. (see Manual section 2090.2)

4010.1.2 INSPECTION CONSIDERATIONS

Generally, it is not the examiner's responsibility to criticize the method of term financing used by a bank holding company. The examiner, however, should be familiar with the various types of leveraging and the possible ramifications that they may have on a holding company structure. While the use of ratios may show an excessive leverage position, indicating vulnerability, it is primarily the corporation's earning power that dictates the acceptable level of debt. Accordingly, the examiner should compute a holding company's ability to meet its fixed charges (as detailed in the preceding section) to determine the appropriateness of the leverage position. If the company's earnings do not support the present fixed charge requirements, or if a declining trend is noted, appropriate comments are warranted.

can lead to what is referred to as "***double leverage***."

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised to incorporate a reference to the "Liquidity Risk" sections (3005.1 to 3005.5) of the Federal Reserve System's Trading and Capital-Markets Activities Manual. *These sections provide additional guidance on evaluating a banking organization's liquidity management.*

4010.2.1 INTRODUCTION

Liquidity is generally defined as the ability of a company to meet its short-term obligations, to convert assets into cash or to obtain cash, or to roll over or issue new short-term debt. "Short-term" is generally viewed as a time span of up to a year. Since a bank holding company does not have the full range of asset and liability management options available to it that a bank does in managing its liquidity position, a BHC needs to have a sufficient cushion of liquid assets to support maturing liabilities. Certain assets that would not normally be considered current may be readily sold to avert a liquidity squeeze. For example, a holding company may be participating in long-term loans originated by a small business investment company (SBIC) subsidiary. If these loans are of good quality, the parent's share may be sold at little or no discount to that SBIC subsidiary, another subsidiary, or an unaffiliated company to obtain the needed cash. Consequently, the breakdown of assets segregating those that are current would not necessarily be indicative of liquid assets, given the nature of bank holding company investments. Therefore, liquid assets are defined as those assets that are readily available as cash or that can be converted into cash on an arm's-length basis without considerable loss.

Liquidity problems are usually a matter of the degree of severity. A less serious liquidity problem may mean that the company is unable to take advantage of profitable business opportunities. A more serious lack of liquidity may mean that a company is unable to pay its short-term obligations and is in default—this can lead to the forced sale of long-term investments and assets and, in its most severe form, to insolvency and bankruptcy. (See SR-86-17 and SR-85-37.) See also the "Liquidity Risk" sections (3005.1 to 3005.5) of the Federal Reserve System's *Trading and Capital-Markets Activities Manual.* These sections provide additional guidance on evaluating a banking organization's liquidity management.

4010.2.2 SUPERVISORY APPROACH TO ANALYZING PARENT COMPANY LIQUIDITY

For bank holding companies with consolidated assets in excess of $1 billion or material amounts of debt outstanding, or others, at the option of the Reserve Bank, the analytical approach to parent company liquidity will include the following key elements:

1. Evaluate parent company liquidity by analyzing the *contractual* maturity structure of assets and liabilities, extending this analysis to consider the underlying liquidity of the parent's intercompany advances and deposits. Any judgment of *adequate* parent company liquidity must be keyed to a finding that the parent has adequate liquid assets, on an underlying basis, to meet its short-term debt obligations.
2. Estimate the underlying liquidity of parent liabilities and assets, giving particular attention to interest-bearing deposits in and advances to subsidiaries. Emphasis should be placed on asset quality and the liquidity profile of the bank and key nonbank subsidiaries. The estimates are to be reflected in a statement of "Parent Company Liquidity Position" as restated data, with appropriate explanations as to the basis for the restatement.
3. Use the five contractual and estimated underlying maturity categories on the statement of "Parent Company Liquidity Position" to slot in data. The data categories are—
   a. up to 30 days,
   b. up to 90 days,
   c. up to one year,
   d. one to two years, and
   e. beyond two years.

   The schedule provides for the use of effective remaining maturity categories for the parent company's short-term assets and liabilities, highlighting funding surpluses or deficits at key specified periods of time. *Examiners have the option of including the statement in the inspection report in order to substantiate or clarify particular judgments.*
4. Use the conclusions drawn from the statement of "Parent Company Liquidity Posi-

tion" as a basis for discussions with management. Examiners should also comment on their findings in detail on the "Analysis of Financial Factors" page in the inspection report.

5. Ascertaining whether an organization with significant funding activities has in place—
   a. internal parent liquidity management policies that address and limit the use of short-term funding sources to support various subsidiaries, and
   b. an internal contingency plan for maintaining parent liquidity under adverse situations.

4010.2.3 STATEMENT OF PARENT COMPANY LIQUIDITY POSITION

The purpose of the statement of "Parent Company Liquidity Position" is to provide a consistent method for analyzing parent liquidity. The schedule is *not* intended to address the issue of interest sensitivity. While only conclusions drawn from the schedule of estimated effective maturities are to appear in the inspection report, examiners should also collect data on contractual (remaining life) maturities of parent assets and liabilities. Examiners will treat all externally funded nonbank entities of the parent company in a similar fashion.

The maturity categories appearing on the schedule are a basic analytical framework for looking at funding mismatches and are not necessarily appropriate for all organizations. As such, categories can be adjusted to fit particular circumstances. On a conceptual basis, the 30-day period corresponds to a period during which markets might be in temporary disarray due to an external shock. For the largest companies with substantial overnight and very short-term funding operations, an additional 1- to 7-day category may be needed. The 31- to 90-day period allows for gauging the parent's ability to withstand internal adversity and demonstrate a return to "normal" business operations. The 91-day to one-year period is a reasonable planning horizon over which an organization might be able to readjust its internal funding policies substantially. In addition, the up-to-one-year categories, as a group, complement the cash-flow analysis of debt-servicing capacity by specifically addressing maturing debt that must be either paid or rolled over at prevailing rates. The one- to two-year category provides an early indication of any funding imbalances that management would have to address in the reasonably near term. As a practical matter, the over-two-year category has limited analytical value in most cases and is included principally to make certain that all deposits and advances are accounted for.

Using these categories, funding surpluses or deficits can be identified for specific maturity intervals. For examiners evaluating gaps based on estimated "underlying" maturities, guidelines on acceptable practices for funding surpluses and shortfalls are set. Examiners would be expected to place particular emphasis on the up-to-30-day period, in which a net liquidity surplus would be expected to provide at least that much time for a parent to ride out a shock. Similarly, the up-to-90-day period would be viewed as the relevant time to demonstrate to the market that problems are being addressed appropriately and are being brought under control. Imbalances in the 91-day to one-year categories would generally have less significance due to greater uncertainty regarding the assumptions that would go into any adjustments.

A logical point for assessing parent liquidity is an assessment of the contractual maturity structure of the holding company's balance sheet. Contractual maturities of assets and normal run-off of liabilities are to be slotted into the five maturity categories depicted. Once completed, the examiner is provided with an initial indication of whether the parent has an adequate cushion of short-term liquid assets within the 0- to 30-day and the 0- to 90-day categories to cover short-term liabilities or whether a pattern of significant short-term funding gaps exists. Certainly, the identification of such gaps gives guidance on obvious areas for further analysis. However, the absence of short-term funding shortfalls on a strictly contractual basis gives only limited comfort, as the parent's underlying liquidity still must be analyzed more deeply.

4010.2.4 ANALYSIS OF UNDERLYING SOURCES TO FUND DEBT AND MEET OTHER OBLIGATIONS

Adjustments to the schedule that better reflect the parent's liquidity position will be made as the next step in the analysis. These adjustments require the examiner's judgment on the underlying liquidity of the parent's assets and liabilities; particular emphasis placed on interest-bearing deposits with bank subsidiaries and advances to both bank and nonbank subsidiaries.

4010.2.4.1 Interest-Bearing Deposits with Subsidiary Banks

The parent's interest-bearing deposits[1] with the subsidiary bank(s) may represent either the temporary placement of idle funds or a more permanent source of bank funding. Temporary deposits typically are structured to mature in 90 days or less, are generally not substantial in relation to the overall size of the bank, are usually supported by substantial holdings of highly liquid bank assets, and could be repaid without triggering marketplace concerns regarding the organization's overall funding needs. Therefore, if this pattern exists, the temporary deposits may be considered highly liquid and slotted in the 0- to 30-day (or 0- to 7-day) period on the schedule, regardless of their contractual maturity dates.

Interest-bearing deposits with the subsidiary bank(s) that serve as a permanent source of bank funds are typically substantial in relation to the size of the bank and are usually placed to fund bank expansion without additional bank borrowings. Here, judgments regarding underlying liquidity should be keyed to the CAMELS ratings on the bank's liquidity and asset quality, as well as reasoned judgments on the bank's ability to liquidate assets or replace the funds in the marketplace through additional borrowings. Asset quality is critical, as it is a leading indicator of bad news that will ultimately pull down earnings and undermine market confidence. As a general principle, the liquidity of the parent's deposits in bank(s) should be no better than the liquidity of the bank(s) and should be subject to downgrading if bank asset quality is suspect. If bank asset quality is worse than fair, the liquidity of these funds should be downgraded. For banks with asset quality rated fair, the parent's deposits might still be considered liquid, but a closer analysis of the particular situation would be warranted.

Under the assumption that the bank's asset quality and liquidity positions do not negatively impact the bank's ability to liquidate or replace these funds, such deposits may be slotted in the 0- to 30-day (or 0- to 7-day for large institutions) period on the schedule, regardless of the contractual maturity. However, if these deposits are substantial, their replacement may trigger market concerns. At this point, the examiner's judgment is necessary to determine an acceptable level at which a portion of the deposits could be replaced in the marketplace without triggering such concerns. A starting point for the examiner should be to evaluate the funding gaps appearing on the contractual maturity schedule with particular attention paid to the 0- to 90-day period (0 to 30 days for large institutions). While it may be impossible for the bank(s) to replace all the parent's deposits without triggering concerns, the bank(s) may be able to replace only the portion necessary to eliminate the negative cumulative funding gap in the given time period. If even this amount is deemed to be substantial, the examiner may have no other alternative but to treat the deposits in accordance with the contractual maturity. For clarification, the following example is provided.

The contractual maturity schedule of a large holding company reflects a negative cumulative gap of $400 million in the 0- to 30-day time frame. The company's balance sheet includes $2.5 billion in interest-bearing deposits at the subsidiary bank(s), with $1 billion maturing in 30 days and $1.5 billion in 31 to 90 days.

In the examiner's judgment, the entire $1.5 billion due in over 30 days qualifies to be slotted in the under-30-day category,[2] but the bank would face liquidity pressures to replace this amount prior to its original maturity. However, $400 million, the amount needed to eliminate the negative cumulative gap position, could be replaced by the bank without undue market concern. Therefore, $400 million from the 31- to 90-day period should be re-slotted in the appropriate under 30-day-period.

4010.2.5 ADVANCES TO SUBSIDIARIES

Given the typical composition of bank holding company assets, the examiner is likely to have difficulty determining the degree of liquidity inherent in advances to subsidiaries.

For those subsidiaries with satisfactory asset quality, the examiner can usually assume the subsidiary could sell qualifying assets to affiliate bank(s) up to the quantitative limitations of section 23A, as long as the affiliated bank(s) are judged to have adequate liquidity. The examiner can also assume that a subsidiary that has an

1. In concept, the parent could also have advances to bank subsidiaries. Such advances are either booked as deposits (typically off-shore time deposits to avoid reserve requirements) or as instruments qualifying as tier 1 or tier 2 capital. To the extent that advances to banks are encountered, the analysis follows the same approach used with deposits.

2. Subject to early withdrawal penalties, which will be eliminated in consolidation.

established program of secondary-market asset sales could at least continue or even modestly expand the scope of the program. For subsidiaries without a program of asset sales, but whose assets are of the type that are readily marketable in the secondary market, a *limited* asset-sale program could be considered to provide some asset liquidity. However, caution should be used in estimating the magnitude of such sales, particularly because large transactions could not be accomplished quickly without risking market visibility and without broadcasting concerns about the corporation's funding.

When nonbank advances are substantial, the parent has little or no practical access to the funds advanced. While an arm's-length sale of such a subsidiary or a large portion of its assets to a bank affiliate may not generate a loss, the funding requirements for a large transaction at the bank level would probably initiate marketplace concerns.[3] Similarly, asset sales to an unaffiliated party that are significantly above normal would not only trigger market concerns but would probably also result in a significant discount. Furthermore, although it is possible that another nonbank subsidiary may act as the funding vehicle, the subsidiary's ability to generate the required funds may be restricted at best. Such restrictions may include marketplace concerns, as well as limitations on the maximum leverage positions or on the creation of senior debt embedded in debt covenants.

Advances to a subsidiary may be either short term or long term and are made for a variety of reasons, including providing a temporary source of income for the parent, enhancing a subsidiary's liquidity position, and supporting a subsidiary's operations. Therefore, the purpose of the loan, its maturity, and the degree to which high-quality assets of a subsidiary cover the amount due to the parent should also be considered in order to properly categorize advances.

4010.2.6. LIQUIDITY AND LIABILITIES OF THE PARENT

For liabilities of the parent, the policy presumption should be that their contractual maturity reflects the underlying availability of funds. Exceptions will reflect special circumstances, such as funding from foreign ownership interests or partners in joint ventures who have equity interests and an ongoing business relationship. The presence of backup lines of credit for commercial paper, while especially desirable in the case of regional companies, should not, by itself, cause an examiner to assume that the underlying maturity of a parent's short-term debt is materially longer than its contractual term or that these lines will always be readily available. In fact, organizations experiencing considerable problems, particularly asset-quality and liquidity problems, may find that these facilities are no longer available.

The examiner should thus review backup lines on a case-by-case basis and be aware of any escape clauses in interbank agreements. Specifically, for companies with a composite 3 or worse bank holding company RFI/C(D) rating or lead banks whose asset quality is a declining 3 or worse *or* whose asset quality *and* liquidity are rated 3 or worse, it is recommended that backup lines with "material adverse change" or similar escape clauses *not* be regarded as satisfactory support to an imbalanced parent company funding position.

Furthermore, certain holding companies' liabilities may often include unamortizing debt instruments. The company's ability to retire or replace such issues at maturity should be evaluated as part of the organization's overall liquidity analysis. If management intends to roll over the maturing issues, the evaluation should be based on the company's ability to do so. When debt retirement is the route chosen by management, the examiner's evaluation and judgment should focus on the company's ability to generate the necessary funds, either through asset liquidation or the issuance of equity instruments.

The unamortizing portion of debt issues is to be slotted in the appropriate maturity column of long-term debt. If the maturity of such issues falls due within the 0- to 90-day time frame, the examiner should comment on the organization's ability to replace the maturing issues or retire them by the deployment of funds from other sources in a footnote on the schedule. If the maturity of such debt is longer, the replacement or retirement should be addressed in the corporation's funding plan.

3. Underlying liquidity estimates should follow the approach previously stated for deposits.

4010.2.7 ANALYZING FUNDING MISMATCHES

After adjustments for the underlying liquidity of the parent's interest-bearing deposits and advances to subsidiaries and the underlying maturity of its liabilities, the resulting schedule should provide the examiner with the framework for looking at funding mismatches as a tool for assessing the parent's overall liquidity position. The position may be evaluated by the analysis of the underlying liquidity gaps (appearing on the bottom of the schedule). In the 0- to 30-day time frame, a net positive gap is expected and reflects the parent's ability to ride out a temporary market disarray. Although a negative gap in the 8- to 30-day period may be evident in larger organizations, the overall 30-day interval is expected to be positive. Similarly, for most organizations, the 0- to 90-day period is expected to reflect a positive position, regardless of a shortfall in the 31- to 90-day period. Failure to meet these conditions requires appropriate examiner comments on the "Examiner's Comments" page of the report.

The 91-day to one-year time frame (as well as the 31- to 90-day period for certain larger organizations) is less critical, and negative cumulative funding positions of modest size may be tolerated if the organization has demonstrated an ability to tap the funding markets, has readily available backup lines of credit, has a reasonable earnings-retention policy, has adequate funds-flow coverage, and has other fund-generating programs (such as a dividend reinvestment plan). Judgments on the reasonableness of any imbalances in these longer-term categories should be weighed against the examiners' estimates of the adequacy of these sources. In addition, the examiner should view these longer periods as a reasonable planning horizon over which the organization should be able to readjust its funding policies. These longer periods also provide an early indication of how management may address funding imbalances that may develop.

A significant shortfall in the 91-day to one-year period is expected to be covered by a contingency funding plan. While no single formula for such plans is recommended or possible, each organization needs to address its particular situation and the options it faces. At a minimum, the organization needs to address possible market shocks, whether they are caused by its own actions or by external events. Funding markets should be addressed individually and as a group, both as to their likely resiliency and the particular organization's position within each market. The viability of contingency sources should be tested periodically. The examiner should review the reasonableness of assumptions and the adequacy of alternative courses as part of the company's liquidity analysis. If no plan exists, a plan acceptable to the corporation's directors should be required. Even if there are no specific concerns, the existence or lack of a plan should be taken into account when assessing management.

In analyzing liquidity, the examiner will encounter the least difficulty when liquid assets equal or exceed short-term liabilities. In those instances, the liquidity position is considered adequate. If the examiner notes a declining trend in the liquidity position, an appropriate comment may be warranted, even though sufficient liquidity exists at that time.

Conversely, the examiner will encounter the most difficulty in analyzing liquidity when liquid assets are not sufficient to cover short-term obligations. When this situation exists, it is not necessarily indicative of an inadequate liquidity position. At that point, the examiner must consider other readily available sources of cash that are not shown on the balance sheet (for example, unused bank lines, dividends from subsidiaries).

Footnotes to financial statements may also play an important role in liquidity analysis. One such footnote may describe indenture restrictions on long-term debt. While a company may temporarily alleviate a liquidity bind by paying off its commercial paper with short-term bank loans, it may be faced with the problem of paying off the bank debt if it is precluded from issuing additional long-term debt.

4010.2.8 REPORTING THE RESULTS OF THE ANALYSIS

In the normal course of the inspection, the examiner should present his conclusions concerning liquidity to management. When there is an indication of some vulnerability, the examiner should solicit management's opinion and any corrective action plans being considered. If it appears that management has not addressed itself to the vulnerable or inadequate situation, an appropriate comment should be made. The results of this analysis should be discussed in the parent company section on the "Analysis of Financial Factors" page in the inspection report. In addition, the examiner has the option of

incorporating the liquidity schedule in the report in order to substantiate or clarify particular judgments. Criticism with respect to a liquidity shortfall anywhere within the 0- to 90-day time frame or, in most cases, the absence of a contingency plan to cover shortfalls in the under-one-year time frame, should be carried forward to the "Examiner's Comments" page and the transmittal letter. These concerns should also be discussed with management.

4010.2.9 INSPECTION OBJECTIVES

1. To analyze the contractual maturity structure of assets and liabilities, and then extend the analysis to the underlying liquidity of intercompany advances and deposits—considering whether the underlying liquidity is short term or long term.
2. To estimate the underlying liquidity of parent liabilities and assets, paying particular attention to interest-bearing deposits in and advances to subsidiaries. Give particular attention to—
   a. asset quality, and
   b. the liquidity profile of the bank and key nonbank subsidiaries.
3. To restate, on the "Parent Company Liquidity Position" report page (see section 5030.0, pages 33–34), the estimates, using the suggested five broad contractual and underlying maturity categories.
4. To judge the adequacy of parent company liquidity, keying it to a finding as to whether the parent has adequate liquid assets, on an underlying-liquidity basis, to meet its short-term debt obligations.
5. For BHCs that have significant funding activities at the parent level, to determine if the parent company has in place—
   a. internal parent liquidity management policies that address and limit the use of short-term funding sources to support subsidiaries, and
   b. an internal contingency plan for maintaining parent liquidity in the face of adversity.
6. To draw conclusions from the estimated remaining effective maturities that appear in the report.

4010.2.10 INSPECTION PROCEDURES

1. Assess the contractual maturities of the parent company's balance sheet.
2. Slot the contractual maturities of assets and the normal runoff of liabilities into the five categories on the "Parent Company Liquidity Position" report page.
3. On the schedule, make adjustments as to the underlying maturity of the parent company's assets and liabilities.
4. Review funding mismatches.
5. Review the reasonableness of the contingency plan's assumptions and the adequacy of alternative sources.
   a. If no plan exists, a plan acceptable to the corporation's directors should be required.
   b. Even if there are no specific concerns, the existence or lack of a plan should be taken into account when assessing management.
6. Discuss the results in the parent company section of the "Analysis of Financial Factors" page in the inspection report.
7. Include in the "Examiner's Comments," page 1, criticism of liquidity shortfalls within the 0- to 90-day period or the absence of a contingency plan to cover shortfalls in the under-one-year time frame that were discussed with management.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2011, this section was revised to provide an introduction to the principal areas of concern when examining a bank, such as the CAMELS components.

In making the determination as to the condition of the holding company under inspection, an examiner must, as part of the inspection procedures, analyze the financial condition of the bank(s) owned by the holding company. Such an appraisal is obviously of paramount importance when one considers that the bulk of the consolidated assets and earnings of a holding company are represented by the bank(s). The examiner must incorporate in the analysis, results of the most recent commercial examination of the subsidiary bank(s).

Therefore, for meaningful results, the analysis of the subsidiary bank(s) should commence after the results of the latest examination of the bank(s) have been obtained. The primary areas of concern are (1) the quality and adequacy of the bank's capital (C); (2) the quality of the bank's assets (A); (3) the capability of the board of directors and management (M) to identify, measure, monitor, and control the risks of the bank's activities and to ensure that the bank has a safe, sound, and efficient operation that is in compliance with applicable laws and regulations; (4) the quantity, sustainability, and trend of the bank's earnings (E); (5) the adequacy of the bank's liquidity (L) position; and (6) the bank's sensitivity (S) to market risk—the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect the bank's earnings, capital, and liabilities that are subject to market risk. See SR-96-38, "Uniform Financial Institutions Rating System," and section A.5020.1 in the *Commercial Bank Examination Manual.* The examiner's analysis of the bank must consider and determine whether certain key facets of a bank's
operations meet minimum standards and conform, where required, to bank regulatory restrictions. The examiner should be especially alert to any exceptions or violations of applicable statutes or regulations that could have a materially adverse effect upon the financial condition of the organization. In addition, the examiner should also consider the conclusions drawn as to the extent of compliance and the adequacy of internal bank policies that contribute to the overall analysis of the bank's condition.

Inspection personnel should use the examination ratings of the other federal agencies (where appropriate) when completing the inspection report. However, if substantive differences of opinion exist as to the bank's composite rating, adjustments to the rating may be made and footnoted to indicate the change.

One area of vital importance in the evaluation of a bank's condition is capital adequacy. Consideration should be given by the examiner whether the bank has sufficient capital to provide an adequate base for growth and a cushion to absorb possible losses, thereby providing protection to depositors. In that regard, the Board, has adopted capital adequacy guidelines, that include risk-based and leverage measures which apply to state member banks. The examiner should refer to section 3020.1 of the *Commercial Bank Examination Manual* for guidance on evaluating the capital adequacy of state member banks.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2011, this section was revised to more clearly explain the components in calculating the total classification ratio and the weighted classification ratio, which are used in determining the asset quality of subsidiary banks. This section was also revised to include references to SR-93-30 and SR-96-38.

The quality of a bank's assets is another area of major supervisory concern. Supervisors consider the appraisal and evaluation of a bank's assets to be one of the most important examination procedures. It will be established by the bank examiner during the examination of a subsidiary bank to what degree its funds have been invested in assets of good quality that afford reasonable assurance of ultimate collectability and regularity of income. The examiner should have further determined that a subsidiary bank's asset composition is compatible with the nature of the business conducted by the bank, the type of customer served, and the locality. The holding company examiner is expected to comment upon the total classifications determined by the bank examiner in relation to the bank's capital.[1] Consideration should also be given to the severity of the classifications. If the classified assets are considered not to possess a significant loss potential, favorable consideration should be accorded this factor.

Past due ratios should also be evaluated. In this respect, it is essential that trends be observed. Although a particular lending department's delinquent outstandings or an institution's overall past due percentage is presently considered reasonable, a noticeable upward trend may be worthy of comment to management. Excessive arrearages in any area warrant an examiner's comment in the inspection report. Management should take appropriate action to improve any undesirable past due levels.

In determining an organization's asset quality, the total classification ratio is an important indicator to review. The total classification ratio is calculated by adding the total dollar value of classified assets divided by the sum of tier 1 risk-based capital plus the allowance for loans and lease losses (ALLL). Another yardstick employed by examiners is the weighted classification ratio, which takes into consideration the severity of a bank's classified assets. In rating asset quality, the weighted classification ratio is designed to distinguish the degree of risk inherent in classified assets by ascribing weights to each category of classification thereby providing another measure of the impact of risk on bank capital.

The following weights are to be used:

Classification	*Weights*
Substandard	20%
Doubtful	50%
Loss	100%

The weighted classification ratio is calculated by taking the aggregate of 20 percent of assets classified substandard and value impaired (net of allocated transfer risk reserve), 50 percent of doubtful, and 100 percent of loss divided by the sum of tier 1 risk-based capital plus the ALLL. In addition to the total and weighted classifications ratios, examiners should also evaluate the adequacy of loan loss valuation reserves as compared to weighted classifications. Loss potential inherent in weighted classified assets must be offset by valuation reserves and equity capital or appropriate comments should be made.

Another tool that should be considered in evaluating asset quality is the bank's internal classification list, if the bank's lending procedures and management are adequate. Additional information on rating a bank's asset quality is available in the Uniform Interagency Bank Rating System. See SR 96-38, "Uniform Financial Institutions Rating System," and section A.5020.1 in the *Commercial Bank Examination Manual.*

1. See SR-93-30, specifically the attachment entitled, "Interagency Statement on the Supervisory Definition of Special Mention Assets." See also SR-04-9 on the attached "Revised Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts," which defines classified assets.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2016, this section was revised to include footnote 1.

Comparison of earnings trends with other banks of similar size, along with an analysis of the quality of those earnings, is an effective initial approach in determining whether or not a bank's earnings are satisfactory. Comprehensive surveys of bank earnings by peer group size are tabulated by the Board and many of the Reserve Banks. The results are sufficiently detailed to permit various methods of comparison of the earnings of a specific bank with those in its peer group.

One ratio used as a means of measuring the quality of a bank's earnings is its return on average assets (net income after taxes divided by average total assets). If the ratio is low or declining rapidly, it could signal, among other things, that the bank's net interest income or margin is declining or that the bank is experiencing increased loan losses.

A bank's current earnings should be sufficient to allow for ample provisions to offset anticipated losses. Various factors to be considered in the determination of such losses include a bank's historic loss experience, the adequacy of the valuation reserve, the quality and strength of its existing loans and investments and the soundness of the loan and administrative policies of management.

In assessing a bank's earnings performance capabilities and the quality of those earnings, an examiner should give consideration to any special factors that may affect a particular bank's earnings. For example, a bank located in an urban area of a large city may find it difficult to earn as much as a bank of similar size located in a rural community or a small city. The urban bank is usually subjected to a higher level of operating expenses, particularly in salaries and local taxes. Moreover, its proximity to the large city and the competition afforded by bigger banks may necessitate lower rates of interest on loans as well as higher rates of interest on deposits. Consideration should also be given to the adequacy of the loan loss provisions as referred to above, the inclusion of any capitalized accrued interest into interest income, or the nature of any large nonoperating gains when analyzing earnings. Further consideration should be given to the general nature of a bank's business or management's mode of operation. A bank's deposit structure and its resulting average interest paid per dollar of deposits may differ widely from that of other banks of a similar size and consequently, its earnings may be substantially below average as a direct result of the difference. For example, the maintenance of a high volume of interest bearing time accounts in relation to total deposits is a major expense and is quite often the cause for certain banks falling below the average earnings of comparably sized banks.

A bank's earnings should also be more than sufficiently adequate in relation to its current dividend rate. It is particularly important that a bank's dividend rate is prudent relative to its financial position and not be based on overly optimistic earnings scenarios. See SR-09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies."[1] Also see section 2020.5 and its discussion of the Board's "Policy Statement on the Payment of Cash Dividends by State Member Banks and Bank Holding Companies."

The percentage that should be retained in the capital accounts is not clearly established. One thing is certain, the need for retained earnings to augment capital will depend on the adequacy of the existing capital structure as well as the bank's asset growth rate. Dividend payout rates may be regarded as exceeding prudent banking practices if capital growth does not keep pace with asset growth. Prudent management dictates that a curtailment of the dividend rate be considered if capital inadequacy is obvious and greater earnings retention is required. Apparently excessive dividend payouts or a record of recent operating losses should lead the bank or BHC examiner to refer to sections 5199(b) and 5204 of the United States Revised Statutes and

1. SR-09-4 is superseded for a U. S bank holding company or an intermediate holding company of a foreign banking organization with $50 billion or more in total consolidated assets as stated in SR-15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms," and SR-15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms."

section 208.19 of Regulation H which restrict state member bank dividends.

Analysis of net interest margins is of growing importance. A comparison should be made of a bank's ability to generate interest income on earning assets relative to the interest expenses associated with the funds used to finance the earning assets.

Additional information on rating bank earnings is available in the Uniform Interagency Bank Rating System. See SR-96-38 "Uniform Financial Institutions Rating System," and section A.5020.1 in the *Commercial Bank Examination Manual.*

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised to incorporate a reference to the "Liquidity Risk" sections (4020.1 to 4020.4) of the Federal Reserve System's Commercial Bank Examination Manual. This section has also been revised to include a reference to the March 2010, "Interagency Policy Statement on Funding and Liquidity-Risk Management."

Liquidity is generally defined as the ability to meet short-term obligations, to convert assets into cash or obtain cash, or to roll over or issue new short-term debt. Various techniques are employed to measure a bank's (depository institution) liquidity position. The bank examiner considers the bank's location and the nature of its operations. For example, a small rural bank has far different needs than a multibillion dollar money market institution.

In addition to cash assets, a bank will hold for liquidity purposes a portion of its investment portfolio of securities that are readily convertible into cash. Loan and investment maturities are generally matched to certain deposit or other liability maturities. However, the individual responsible for a bank's money management must be extremely flexible and have alternate means to meet unanticipated changes in liquidity needs. To offset these needs, other means of increasing liquidity may be needed, which might include increasing temporary short-term borrowings, selling longer-term assets, or a combination of both. Factors that the "money management" officer will consider include the availability of funds, the market value of the saleable assets, prevailing interest rates and the susceptibility to interest-rate risk, and the bank's earnings position and related tax considerations. Although most small banks may not have a "money manager," they too must monitor their liquidity carefully.

One of the most common methods used by large banks to increase liquidity is to use additional borrowings. Some of the other basic means of improving liquidity include the use of direct short-term credit available through the discount window from Reserve Banks, the use of Federal funds purchases, and the use of loans from correspondent banks.

4020.4.1 SOUND LIQUIDITY-RISK MANAGEMENT

All banks are affected by changes in the economic climate, and the monitoring of economic and money market trends is crucial to liquidity planning. Sound financial management can minimize the negative effects of these trends while accentuating the positive ones. Sound liquidity-risk management requires the following elements:[1]

- Effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution's control of liquidity risk.
- Appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk.
- Comprehensive liquidity-risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution.
- Active management of intraday liquidity and collateral.
- An appropriately diverse mix of existing and potential future funding sources.
- Adequate levels of highly liquid marketable securities free of legal, regulatory, or operational impediments that can be used to meet liquidity needs in stressful situations.
- Comprehensive contingency funding plans (CFPs) that sufficiently address potential adverse liquidity events and emergency cash flow requirements.
- Internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity-risk management process.

Information that a bank's management should consider in liquidity planning includes—

1. internal costs of funds,
2. maturity and repricing mismatches in the balance sheet,

1. See the March 10, 2010, "Interagency Policy Statement on Funding and Liquidity-Risk Management." (See section 4066.0, appendix A.) See also the guidance published by the Basel Committee on Banking Supervision, Bank for International Settlements, "Principles for Sound Liquidity-Risk Management and Supervision."

3. anticipated funding needs, and
4. economic and market forecasts.

In addition, bank management must have an effective CFP that identifies minimum and maximum liquidity needs and weighs alternative courses of action designed to meet those needs. Some factors that may affect a bank's liquidity include—

1. a decline in earnings,
2. an increase in nonperforming assets,
3. deposit concentrations,
4. a downgrade by a rating agency,
5. expanded business opportunities,
6. acquisitions,
7. new tax initiatives, and
8. assured accessibility to diversified funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings.

Adequate liquidity contingency planning is critical to the ongoing maintenance of the safety and soundness of any depository institution. Contingency planning starts with an assessment of the possible liquidity events that an institution might encounter. The types of potential liquidity events considered should range from high-probability/low-impact events that can occur in day-to-day operations to low-probability/high-impact events that can arise through institution-specific or systemic market or operational circumstances. Responses to these events should be assessed in the context of their implications for an institution's short-term, intermediate-term, and long-term liquidity profile. A fundamental principle in designing a CFP that addresses each of these liquidity tenors is to ensure adequate diversification in the potential sources of funds that could be used to provide liquidity under a variety of circumstances. Such diversification should focus not only on the number of potential funds providers but also on the underlying stability, availability, and flexibility of funds sources in the context of the type of liquidity event these sources are expected to address.

See also the "Liquidity Risk" sections (4020.1 to 4020.4) of the Board of Governors of the Federal Reserve System's *Commercial Bank Examination Manual.* These sections provide additional guidance on evaluating a banking organization's liquidity management.

4020.4.2 LIQUIDITY-RISK MANAGEMENT USING THE FEDERAL RESERVE'S PRIMARY CREDIT PROGRAM

The Federal Reserve's primary credit program (a type of discount window lending) offers generally sound depository institutions an additional source of available funds, although such funds are lent for managing short-term liquidity risks (at a rate above the target federal funds rate).[2] Management should fully assess the potential role that the Federal Reserve's primary credit program might play in managing the institution's liquidity. The primary credit program can be a viable source of very short-term backup funds. Management may find it appropriate to incorporate the availability of the primary credit program into their institution's diversified liquidity-management policies, procedures, and CFPs. The primary credit program has the following attributes that make it a viable source of backup or contingency funding for short-term purposes:

1. Primary credit is extended, with minimal administrative burden, to eligible discount window participants.
2. Primary credit is available only to financially sound depository institutions, as determined by the lending Federal Reserve Bank.
3. Primary credit can enhance diversification in short-term CFPs.
4. Borrowings can be secured with an array of collateral that is acceptable to the lending Federal Reserve Bank, including consumer and commercial loans.
5. Requests for primary credit advances can be made anytime during the day.[3]
6. There are generally no restrictions on the use of short-term primary credit.

If an institution incorporates primary credit into its CFP, the institution should ensure that it has in place with the appropriate Reserve Bank the necessary borrowing documentation and collateral arrangements. This is particularly impor-

2. The Federal Reserve's secondary credit program provides loans to qualifying depository institutions (for example, those depository institutions that are not eligible for the primary credit program) at an interest rate that is above the primary credit program's interest rate. See section 3010.1 of the *Commercial Bank Examination Manual* and SR-03-15, "Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management," for a further discussion of the Federal Reserve's credit programs.

3. Advances generally are booked at the end of the business day.

tant when the intended collateral consists of loans or other assets that may involve significant processing or lead time for pledging to the Reserve Bank.

It is a long-established sound practice for institutions to periodically test all sources of contingency funding. Accordingly, if an institution includes the Federal Reserve's primary and other credit programs, along with borrowing from other lenders, in its contingency plans, management should occasionally test the institution's ability to borrow from all the funding sources covered by the plan. The goal of such testing is to ensure that there are no unexpected impediments or complications in the case that such contingency lines need to be used.

Institutions should ensure that any planned use of primary credit is consistent with the stated purposes and objectives of the program. Under the primary credit program, the Federal Reserve generally expects to extend funds on a very short-term basis, usually overnight. Therefore, as with any other type of short-term contingency funding, institutions should ensure that any use of primary credit facilities for short-term liquidity contingencies is accompanied by viable take-out or exit strategies to replace this funding expeditiously with other sources of funding. Institutions should factor into their CFPs an analysis of their eligibility for primary credit under various scenarios, recognizing that if their financial condition were to deteriorate, primary credit may not be available. Under those scenarios, secondary credit may be available.

Secondary credit is available at a rate above that of primary credit. Secondary credit is available to meet short-term needs (when the borrowing is constant and there is a prompt return to market funding sources) or to resolve financial difficulties. The preparations made by a bank to access primary credit (the documentation and collateral requirements) will also support the borrowing of secondary credit.

Another critical element of liquidity management is an appropriate assessment of the costs and benefits of various sources of potential liquidity. This assessment is particularly important in managing short-term and day-to-day sources and uses of funds. Given the above-market rates charged on primary credit, institutions should ensure that they adequately assess the higher costs of this form of credit relative to other available sources. Extended use of any type of relatively expensive source of funds can give rise to significant earnings implications that, in turn, may lead to supervisory concerns.

It is also important to note that the Federal Reserve's primary credit facility is only one of many tools institutions may use in managing their liquidity-risk profiles. An institution's management should ensure that the institution maintains adequate access to a diversified array of readily available and confirmed funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings. (See SR-03-15.)

4020.4.2.1 Supervisory and Examiner Considerations

Because primary credit can serve as a viable source of backup, short-term funds, supervisors and examiners should view the occasional use of primary credit as appropriate and unexceptional. At the same time, however, supervisors and examiners should be cognizant of the implications that too-frequent use of this source of relatively expensive funds may have for the earnings, financial condition, and overall safety and soundness of the institution. Overreliance on primary credit borrowings, or any other single source of short-term contingency funds, regardless of the relative costs, may be symptomatic of deeper operational or financial difficulties. The use of primary credit, as with the use of any potential sources of contingency funding, is an important management decision that must be made in the context of safe and sound banking practices.

4020.4.3 ANALYSIS OF LIQUIDITY

A bank's liquidity must be evaluated on the basis of the bank's capacity to satisfy promptly its financial obligations and its ability to fulfill the reasonable borrowing needs of the communities it serves. An examiner's assessment of a bank's liquidity management should not be restricted to its liquidity position on any particular date. Indeed, the examiner should also focus his or her efforts toward determining the bank's liquidity position over a specific time period. The examiner's evaluation should also encompass the overall effectiveness of the institution's asset-liability management and liquidity risk-management strategies. Factors such as the nature, volume, and anticipated takedown of a bank's credit commitments should also be considered in arriving at an overall rating for liquidity.

If the bank examiner has commented on a

liquidity deficiency at a subsidiary bank, the bank holding company examiner should consider these findings in the overall analysis of financial factors. Additional information on rating a bank's liquidity is available in the Uniform Interagency Bank Rating System. See SR-96-38, "Uniform Financial Institutions Rating System," and section A.5020.1 in the *Commercial Bank Examination Manual.*

The condition of a bank provides important insight regarding the quality of bank management. An appraisal of management's performance should be measured in terms of long-term profitability, risk exposure, liquidity, and solvency; all geared toward assuring the bank's continued profitability and overall sound financial condition. Management must meet the bank's challenges and position in the market place among its competitors. It must make plans which will achieve the objectives established by the bank's directors. Management must be constantly alert to the need for continued upgrading and expanding of services and facilities to advance, support, and encourage the bank's growth.

Just as sound management decision making will generally produce banks that are free from serious problems, ineffective management has invariably been a prominent factor in almost every serious problem bank situation. An examiner must consider the degree and severity of problems that exist in the bank under examination and attempt to establish the responsibility for such. The examiner should seek to determine to what degree the bank's problems are attributable to questionable management judgment as opposed to outside factors, such as unfavorable economic conditions.

The major portion of a bank holding company's consolidated assets are held in the bank subsidiaries. Furthermore, at the parent level, the major asset is generally the investment in subsidiaries, the principal portion of which is the investment in the bank(s). Therefore, with few exceptions, it is the overall condition of the bank subsidiaries that reflects the condition of the parent company. As the bank holding company examiner reviews the examination report(s) for each bank subsidiary, a decision must be made with respect to the general condition of each bank. When all the bank subsidiaries have been reviewed, the examiner must put these findings within their proper perspective. For example, if four of five bank subsidiaries comprise less than 10 percent of the combined banking assets, it is the condition of the fifth bank subsidiary that will weigh heavily in the analysis. In other words, if the fifth bank comprises 90 percent of the combined banking assets, the parent's investment in that bank also comprises most of the holding company's assets. Thus, the quality of the parent's assets would be reflected in the general condition of that bank and appropriate comments are warranted. It should be noted, however, that regardless of relative size, a bank experiencing problems should be commented upon in the summary analysis.

4020.9.1 DE NOVO BANK DEFINITION AND SUPERVISION POLICY

The term "de novo bank" refers to a state member bank that has been in operation for three years or less. Experience has shown that pronounced problems often surface in the early years of a de novo bank. Problems observed by supervisors have included a lack of experienced management, a revolving door in staffing and directors, dissension among directors, a lack of involvement of directors in strategic planning, and poor lending practices.

Because of the unique challenges faced by de novo state member banks, the Federal Reserve has provided guidance regarding supervisory expectations for such institutions, which are found in SR-20-16, "Supervision of De Novo State Member Banks." SR-20-16 applies to de novo insured depository institutions seeking to become state member banks, as well as to any commercial bank, thrift, Edge Act corporation, or industrial bank that has been in existence for less than three years and is converting to become a state member bank.

This section explains supervisory expectations for a de novo state member bank's capital positions and capital distributions. For more information on submitting a de novo bank application as well as the examination frequency and scope for de novo banks, see SR-20-16, the *Commercial Bank Examination Manual's* section entitled, "Examination Strategy and Risk-Focused Examinations," as well as SR-08-5, "Processing of De Novo Bank Membership Applications."

4020.9.2 CAPITAL STANDARDS FOR SUBSIDIARY BANKS OF BANK HOLDING COMPANIES

A de novo state member bank subsidiary of a bank holding company should maintain capital ratios commensurate with its risk profile and, generally, well in excess of regulatory minimums. The Federal Reserve typically requires a de novo bank to maintain a tier 1 leverage ratio of at least 8 percent for the first three years of operation. The Reserve Bank should consult Board supervision staff when the tier 1 leverage ratio of a de novo falls below 8 percent. Examiners should also scrutinize de novos that rely on additional capital infusions to meet this minimum requirement and understand the stability of the capital source.

Any exceptions to this policy that are being considered for converting banks should be discussed with Board staff.

4020.9.3 CAPITAL DISTRIBUTIONS

A de novo state member bank should generally ensure that it has sufficient earnings and capital to support its growth projections and any capital distributions, as well as its ongoing capital needs. As described in SR-20-16, a de novo should receive two consecutive CAMELS ratings of "1" or "2," based on full-scope examinations, before making such distributions. Further, the de novo's parent bank holding company (if applicable) should assess the risk associated with taking on significant debt that is solely reliant on dividends from the de novo bank subsidiary to service the debt obligation. This guideline is not intended to discourage dividends used by a parent bank holding company to pay the de novo bank's income taxes.[1]

See also the Board's "Small Bank Holding Company and Savings and Loan Holding Company Policy Statement" (12 CFR part 225, appendix C), which permits the formation and expansion of small holding companies with debt levels that are higher than typically permitted for larger holding companies. The policy statement contains several conditions and restrictions designed to ensure that small holding companies that operate with the higher levels of debt permitted by the policy statement do not present an undue risk to the safety and soundness of their subsidiary banks.

1. Refer to SR-98-38, "Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure," and SR-14-6, "Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure." See also this manual's section entitled, "Taxes (Consolidated Tax Filing)."

4030.0.1 INTRODUCTION

Generally, a subsidiary of a bank holding company is not liable for debts of any other subsidiary of the holding company unless it is contractually obligated through guarantees, endorsements, or other similar instruments. This apparent legal separation may induce false confidence that banks are insulated from problems that may befall other subsidiaries of the holding company. If a nonbank subsidiary of a bank holding company finds itself in serious financial trouble, several results are possible. The holding company may work as it was intended, in that debts of the failing subsidiary are isolated and not transferred to other subsidiaries so that at worst, the subsidiary and the parent (the holding company) fail. In this instance, other subsidiaries, including bank subsidiaries, are unharmed, and after a change in management or ownership, they continue in operation. There is no loss of confidence in the bank by its depositors. However, this is not necessarily the result.

Failure of a nonbank subsidiary may lead to a lack of confidence in the affiliated bank's ability to continue in business, which might precipitate a run on the bank's deposits. The failure of a major nonbank subsidiary then may place its affiliated bank in serious financial trouble. The examiner should assess the impact that the failure or the potential failure of a nonbank subsidiary may have on an affiliated bank with a similar name.

Usually, a financially distressed nonbank subsidiary is aided by the holding company, which will do everything in its power to rescue it from failure. At a minimum, refusal to do so would undermine confidence in the strength of the holding company. Refusal to aid its nonbank subsidiary might even result in a rise in the interest cost of the holding company's future debt in the capital markets and, more than likely, preclude issuance of commercial paper.

A holding company has considerable discretion in choosing how to assist one of its troubled subsidiaries. Because the bank is usually the largest subsidiary, the holding company may attempt to draw upon the resources of the bank to aid the nonbank subsidiary. The bank can transfer a substantial portion of its capital through dividends to the parent company, which may pass these funds on to the troubled nonbank subsidiary. Also, the nonbank may attempt to sell part of its portfolio to the bank subsidiary to improve liquidity. The Board's Interpretation 12 C.F.R. 250.250 (at FRRS 3–1133) limits the sale of nonbank subsidiary loans to the bank affiliate unless the bank had an opportunity to appraise the credit at the inception of the loan. Therefore, the examiner should closely analyze the off-balance-sheet activity of the nonbank subsidiary, particularly activity relating to the sale of loans shortly after they are made. Reference should also be made to section 2020.7, regarding the transfer of low-quality loans or other assets to avoid classification.

4030.0.2 ANALYSIS OF FINANCIAL CONDITION AND RISK ASSESSMENT

Because of the potentially damaging effect on the parent company or its bank subsidiary, the examiner should conduct a detailed analysis of the financial condition and perform a risk assessment of the nonbank subsidiaries. The loss to the holding company may not be confined to the equity in and advances to the subsidiary. The contingent liabilities arising from the nonbank subsidiary's external borrowings are quite often a large multiple of the parent's investment. Particular attention should be directed to holding companies that have made massive capital injections in order to rescue a failing subsidiary or to satisfy the external debt obligations of the subsidiary.

For each bank holding company with nonbank activities, examiners should prepare a written risk assessment of each active nonbank subsidiary, addressing the financial and managerial concerns outlined below.[1] This assessment should be performed with the same frequency required for full-scope inspections. The purpose of this assessment is to identify subsidiaries with a risk profile that warrants an on-site presence, even if the subsidiary does not meet the minimum criteria set forth in section 5000.0.4.4.1, ''On-site Reviews of Nonbank Subsidiaries.'' In formulating this assessment, the examiner should consider all available sources of information including, but not limited to—

- findings, scope, and recency of previous inspections;

1. The assessment of nonbank activities in large, complex organizations may be focused on an intermediate-tier company with oversight responsibility for multiple nonbank subsidiaries.

- ongoing monitoring efforts of surveillance and financial analysis units;
- information received through first-day letters or other pre-inspection communications;
- regulatory reports and published financial information; and,
- reports of internal and external auditors.

The risk assessment should address each nonbank subsidiary's funding risk, earnings exposure, operational risks, asset quality, capital adequacy, contingent liabilities and other off-balance-sheet exposures, management information systems and controls, transactions with affiliates, growth in assets, and the quality of oversight provided by the management of the bank holding company and nonbank subsidiary. The examiner should give particular attention to appraising the quality of a nonbank subsidiary's assets because asset problems therein may lead to other financial problems in the nonbank subsidiary and the parent company or bank affiliates. Examiners are expected to document in the inspection workpapers their assessment of the overall risk posed by each nonbank subsidiary and to summarize their assessment of nonbank activities in the bank holding company inspection report.

The examiner has four alternatives with respect to asset classifications. An appraisal of the degree of risk involved in a given asset leads to a selection. The examiner can either ''pass'' the asset or adversely classify the asset ''substandard,'' ''doubtful'' or ''loss,'' depending on the severity of deterioration noted.

Since the preponderance of all loans are subject to some degree of risk, the following question arises: To what point, or degree, must a given credit deteriorate to warrant a scheduled criticism in the report of inspection? Generally, a passed credit has those characteristics which are recognized as being part of a normal risk asset; the degree of risk is not unreasonable, the loan is being properly serviced, and is either adequately secured or repayment is reasonably assured from a specific source.

Classification units are designated as ''substandard,'' ''doubtful,'' and ''loss.'' A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the nonbank subsidiary will sustain some loss if the deficiencies are not corrected. An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified loss are considered uncollectible and of such little value that their continuance as recordable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer reserving against this basically worthless asset even though partial recovery may be effected in the future.

Although the System does not apply bank standards when classifying nonbank assets, the classification categories are the same. Examiners of BHC nonbank subsidiaries must appraise the assets in light of industry standards and conditions inherent in the market.

For information on classifying a parent's investment in and advances to a noncredit-extending subsidiary, see Manual section 4070.0, BHC Rating System.

For information on the sufficiency of nonbank valuation reserves, see Manual section 4030.4.

When analyzing the earnings of a nonbank subsidiary, the examiner should address two primary questions: (1) Is the return on assets commensurate with the risk associated with the assets? (2) What is the impact of earnings and trends on the parent company and affiliate banks? While a nonbank subsidiary operating at a loss may be in less than satisfactory condition, the loss may not necessarily result in a major adverse impact on the consolidated earnings. The nonbank subsidiary's total assets may be insignificant in relation to the consolidated assets of the BHC, but operating losses may result in a significant reduction in its consolidated earnings position.

In some cases, industry statistics will be available for comparative purposes. However, a favorable comparison should not necessarily be taken as depicting a satisfactory earnings condition. Actions by the parent company could influence the earnings of its subsidiaries. For example, management and/or service fees can be adjusted in order to alter the subsidiary's earnings to desired levels. Also, if the parent company is funding the subsidiary, the cost of funds to the subsidiary can be adjusted above or below the parent's cost of funds thus affecting net income. In addition, an undercapitalized subsidiary with only a marginal return on assets could show a better return on equity than the adequately capitalized independent counterpart experiencing a good return on its assets. As important as return on equity is as a measure of performance, for nonbank subsidiaries, particularly those that are thinly capitalized, absolute level of earnings or return on assets provide a more meaningful measure of earnings performance.

The cash return to the parent from its investment in and advances to a subsidiary less its costs to carry the assets and related expenses should exceed the cash return available from an investment of a similar amount in securities in order to justify retaining the subsidiary. If it seems that an alternative employment of funds would be more rational, the examiner should inquire as to management's plans to improve subsidiary earnings.

Questions to be answered in analyzing the earnings of credit-extending nonbank subsidiaries include:

1. What is the impact on the parent company and affiliate banks of a nonbank subsidiary operating at a loss?
2. Is the return on assets commensurate with the risk inherent in the asset portfolios for those nonbank subsidiaries operating profitably?
3. Are intercompany management/service fees appropriate? From a supervisory perspective, management and service fees should have a direct relationship to and be based solely upon the fair value of goods and services received.
4. Is the subsidiary required to reimburse the parent for the parent's interest expense on borrowed funds, the proceeds of which have been treated as ''advances to subsidiaries?''
5. Is the quality of the subsidiary's earnings sound? For example, is the company understating the provision for loan losses, relying upon nonoperating gains or capitalization of accrued interest?

Special attention should be directed by the examiner to the computation of the company's net interest margin (interest income–interest expense, divided by average earning assets). A study of company yields on investments should provide a measure of the company's ability to invest its funds in earning assets that provide a rate of return above the company's cost of funds. As net interest margins narrow, the company may find it more difficult to generate sufficient income to meet operating expenses.

When discussing growth in earnings, the examiner should clearly differentiate between increases due to increased net interest income on a constant base of earning assets as compared to an increase in the earning asset base with a concurrent proportional increase in net interest income. Any improvement in net interest income as a percentage of earning assets may reflect favorably on management's ability to invest its funds at favorable yields or its ability to find less expensive sources of funds.

As a general rule, credit-extending nonbank subsidiaries are funded by the proceeds of parent company borrowings through instruments such as commercial paper or medium to long-term debt or a combination thereof. Equity generally represents only a small portion of funding resources. There are instances, however, where the nonbank subsidiary will arrange direct funding from external sources. This is especially true in certain States where there are tax advantages associated with direct external funding.

Heavy reliance on borrowed funds by a nonbank subsidiary together with its limited capital position often results in a highly leveraged financial condition that is quite sensitive to changes in money market cost of funds. An examiner should consider what a change in the company's cost of funds might do to its net interest margin and earnings.

Many BHCs operate on the premise that a nonbank subsidiary needs little capital of its own as long as the parent company is adequately capitalized. Implicit in this operating practice is management's belief that the parent could act as a source of financial strength to its subsidiary in the event of difficulty at the subsidiary level. However, experience has indicated that in many cases, once trouble has developed in the subsidiary, the parent is hesitant to direct additional funds to the subsidiary, arguing that it is best to limit losses and exposure and it is imprudent for the parent to inject additional capital at this time. Given this experience, it is often considered appropriate for an examiner to comment on a subsidiary's extended leveraged position, indicating to management that the company has little, if any, capital ''cushion'' with which to absorb any asset ''shrinkage'' or loss. The examiner may then conclude and possibly recommend that additional capital be provided for the credit-extending nonbank subsidiary so that its leverage may be reduced and its capital structure altered to reflect more closely an independent organization in the same or similar industry.

Funding should be reviewed to determine that the subsidiary (or the parent) is not mismatching maturities by borrowing short-term funds and applying them to long-term assets that are not readily convertible into cash. A mismatch of maturities can lead to serious liquidity problems.

A primary concern of the holding company examiner is to determine whether the nonbank subsidiary has the capacity to service its debt in an orderly manner. Does the credit-extending nonbank subsidiary have sufficient liquidity and how much will it have to rely on the parent company for funds to retire debt to unaffiliated parties? Factors to be considered include:

1. The subsidiary's asset quality and its ability to convert assets into cash at or near current carrying value. Consider the maturities of borrowings and whether they align with the scheduled assets that will be converted to cash.

2. The subsidiary's and the parent's back-up bank lines of credit available in the event commercial paper cannot be refinanced.

3. The parent company's ability to require its bank or other nonbank subsidiaries to upstream extra dividends to support the illiquid position of one or more of its nonbank subsidiaries.

The purpose of a credit-extending nonbank subsidiary's reserve for bad debts is to provide for known and potential losses in its assets. Although there is no specific formula for measuring the adequacy of a reserve for bad debts, prudence dictates that the reserve account should be maintained at a ''reasonable'' level. What is reasonable depends on the quality of the subsidiary's assets, its collection history and other facts. However, from a supervisory perspective, the reserve for bad debts should at least provide total coverage for all assets classified ''loss'' and still be sufficient to absorb future, unidentified, ''normal'' losses, that are estimated based on the ''doubtful'' and ''substandard'' classifications and the company's historic experience. Valuation reserves for a going concern are not considered adequate unless they can absorb 100 percent of identified losses and still have a balance sufficient to absorb future losses from continued operations.

Examiners should recommend the maintenance of valuation reserves sufficient to offset classified losses and may recommend (as opposed to require) that management charge-off the losses to the reserve account. The charge-off of classified losses is considered appropriate in order to assure that financial statements accurately reflect the company's financial condition. The Federal Reserve System has the responsibility to monitor the bank holding company's nonbank subsidiary statements for accuracy and completeness. Failure by management to reflect accurately the financial condition of the subsidiary and/or parent company could result in a formal corrective action to require charge-offs or other adjustments to financial statements.

For additional information, see Manual section 4030.1, ''Classifications.''

The noncredit-extending nonbank subsidiaries provide services or financial products other than extensions of credit. Some of these companies are insurance agencies, credit life and credit accident and health insurance underwriting companies, electronic data processing centers, management consulting firms and advisory companies.

The operations of some insurance agencies are conducted on the premises of the bank subsidiary(ies) by personnel who often serve as officers or employees of the bank. These companies usually incur little or no liabilities and require only nominal capitalization because risk is limited. However, their commission income is often substantial and a steady source of funds for the parent company. Nevertheless, insurance ''underwriters'' typically have strong capital bases, good liquidity and profitable operations. Furthermore, their operating risks are generally stable and predictable.

Electronic data processing centers are often established under section 4(c)(8) of the Act, which permits them to sell their services to affiliated and unaffiliated customers. Section 4050.0 of this Manual cites examples of how an EDP servicer can have an unfavorable impact on the parent company or its affiliates. Management consulting firms and advisory companies usually require little capitalization and no funding and generate favorable earnings. Of the noncredit-extending subsidiaries, insurance underwriters and EDP servicers are generally the only companies requiring capital and funding in significant amounts.

However, all subsidiaries are subject to some level of risk, which could impact on the BHC. In the case of insurance underwriters, insurance benefits paid could exceed actuarial estimates. Such a situation, however rare, could necessitate financial support from the parent company. EDP servicers could, as a result of excessive computer down-time or equipment obsolescence, impact on consolidated earnings or require additional capital contributions. In addition, contingent liabilities, resulting from legal actions or failure to perform, could be a large multiple of a subsidiary's capital and may affect the parent.

4040.0.1 EARNINGS

In analyzing these subsidiaries, the examiner should consider the following:

1. Are any noncredit-extending subsidiaries operating at a loss or incurring low levels of earnings? If so, what is the cause and does it have a material impact on consolidated earnings?

2. Does the loss result in the subsidiary's reliance on the parent company or bank subsidiary(ies) for financial support? If so, in what form is the support provided?

3. If a loss has been incurred, has management initiated corrective measures? If not, why not?

4. Are the fees charged by the parent for services rendered limited to their *fair market value*? The answer to this question will almost always depend on information supplied by management. Management should be aware of the fair market rates charged by their competitors for similar services rendered.

5. Are the rates charged affiliates commensurate with the services provided and similar to rates charged nonaffiliated customers?

4040.0.2 RISK EXPOSURE

In noncredit-extending subsidiaries, risk exposure, of any meaningful magnitude, is often related to possible losses arising from legal actions for failure to perform services as contracted. The examiner should determine that the subsidiaries are being operated effectively by experienced and competent personnel under the direction of satisfactory management. The examiner should further determine that parent company management exercises appropriate controls over the activities of the subsidiary. Because of potential liability, the examiner should ascertain whether the subsidiaries have adequate insurance coverage (i.e., errors and omissions, public liability, etc.). The examiner should be alert to any contingent liabilities that would have a significant impact of the parent company. For example, the parent company might guarantee the payment of debt or leases for the subsidiary.

The internal services subsidiaries generally derive their business only from the parent company and its affiliates. Examples of such companies include forms printing firms, owners and operators of banking premises, and EDP servicing companies. Banking premises subsidiaries are established to hold or operate properties used wholly or substantially by the parent's subsidiary for its banking business. Generally, their operations do not impact unfavorably on the parent company. However, in instances where the banking premises are not wholly occupied by a banking subsidiary, the examiner should ascertain that the excess space is fully leased/rented. A high vacancy level could result in unprofitable operations or result in an abnormal rental charge to the banking subsidiary in order to operate the subsidiary on a profitable, or break even, basis.

EDP service centers provide bookkeeping or data processing services for the internal operations of the holding company and its subsidiaries, and store and process other banking, financial or related economic data. Generally, these service centers do not have a material effect on consolidated earnings performance as they provide essential services at costs comparable or below their independent counterparts. They usually operate on a break-even basis or at a nominal profit. However, there are some subsidiaries, including EDP servicers, which also provide services indirectly to unaffiliated concerns. EDP servicers operating under section 4(c)(1)(C) of the Act, may provide services to customers of its bank affiliates, provided that the service contract is between the bank and the customer. EDP servicers that operate as independent subsidiaries under section 4(c)(8) of the Act are not similarly restricted and are not considered "not for profit" organizations.

A financial analysis of a "not for profit" service subsidiary should concentrate on the organization's ability to control its expenses and its ability to provide its services to its affiliates at fair market value. Failure to control expenses may result in excessive charges to affiliates to the detriment of the affiliate.

For purposes of an analysis of earnings, analysts of bank holding companies have placed considerable weight on consolidated BHC financial data. Consolidated data, however, can be very misleading since bank assets and revenues are large in relation to their profit margins. On the other hand, the volume of nonbank assets is generally not nearly as large, but profit margins (or losses) tend to be much more substantial. The organizational structure of a holding company is of prime importance and must first be taken into consideration before attempting to analyze consolidated earnings. As an example, in the case of nonoperating shell bank holding companies with no nonbank subsidiaries, the earnings of the bank subsidiary should be nearly identical with consolidated earnings for the organization. Therefore, in these instances, the views and ratings of the applicable bank regulatory agency would normally be accepted and would apply to consolidated earnings of the BHC. This treatment would not apply to one-bank and multi-bank holding companies with substantial credit-extending nonbank subsidiaries. These holding companies require an in-depth analysis of earnings because of the adverse impact that a poorly operated subsidiary can have upon the consolidated earnings of the BHC.

In order to properly analyze consolidated earnings, it is best to review and study a consolidating statement of income and expense for the purpose of determining each entity's contribution to earnings. It is important to recognize that there need be no direct correlation between the asset size of a subsidiary and its relative contribution to total consolidated earnings. For example, a subsidiary accounting for a minute portion of consolidated assets could substantially negate satisfactory earnings of its larger asset base affiliates because of poor operations and sizeable losses.

When evaluating consolidated earnings, it is important to review the component parts of earnings for prior interim or fiscal periods for comparative purposes in order to determine trends. Considerable attention is to be focused on the various income and expense categories. The net interest income (difference between interest income and interest expense) of a company is highly revealing as it will give an indication of management's ability to borrow at attractive rates and employ those funds with maximum profitable results.

Items having a significant impact on earnings include the noncash charge, ''provisions for loan losses'' and the volume of nonaccrual and renegotiated or restructured credits. A large provision for loan losses is made necessary by poor quality assets which result in large charge-offs to valuation reserves. In order to replenish the reserve for loan losses to adequate levels to provide ample coverage against known and potential losses, large amounts of revenues must be ''set aside.'' Nonperforming and renegotiated credits either provide no income or provide a reduced rate of income to the extent that the assets are no longer profitable relative to the cost of funds and the cost of doing business. In situations where earnings are below average or unsatisfactory, a comment concerning the amount of provision for loan losses and volume of nonperforming loans is warranted in the financial analysis.

Other items of significance include taxes, particularly where tax credits are indicative of loss operations, and extraordinary or nonrecurring items. Extraordinary gains or losses are not the result of the normal operations of a company and should be analyzed independently from operating earnings. Generally, extraordinary items result from the sale of current or fixed assets. When significant amounts are involved, examiners should determine the underlying reasons behind such transactions.

After an analysis has been made of the pertinent components of earnings, analyze the ''bottom line'' or net income of the consolidated company. Generally, analysts relate net income to several benchmarks in order to evaluate performance. The ratios of earnings as a percentage of average equity capital or average assets are most widely used. Conclude the analysis with a comparison of a company's ratios in relation to its peer group.

Comparatively low earnings relative to its peer group may be a reflection of problems and weaknesses such as lax or speculative credit practices (resulting in nonearning assets or loan losses), high interest costs resulting from excessive debt, or rapid expansion into competitive industries subject to wide variations in income potential.

Earnings on a consolidated basis are the best measure of performance. Moreover, while the earnings of individual subsidiaries must not be ignored, the ability of holding company management to control the level of reported earnings in any one subsidiary reaffirms the practi-

cality of using the consolidated approach to analyze holding company profitability.

Essentially, the following points summarize areas which should be considered when analyzing consolidated earnings:

1. The return on consolidated assets and equity capital, as well as historical trends and peer group comparisons.

2. The ability of earnings to provide for capital growth, especially when taking into consideration recent and planned asset and deposit growth.

3. The ''quality'' of earnings is affected by the sufficiency of the provision to loan loss reserves and the asset quality of the organization. A high level of earnings that did not include sufficient provisions to the loan loss reserve during a period of high charge-offs may result in reductions in the reserve balance and thereby call to question the merits of high earnings in the face of declining reserve balances.

4. The ability of management to prepare realistic earnings projections in light of the risk structure and quality of assets.

The evaluation of asset quality based on classifications of ''substandard, doubtful and loss,'' is one of the most important elements to be taken into consideration when performing a financial analysis of a holding company because of the severe impact that poor quality assets can have on the overall condition of the organization. Procedures to measure asset quality of banks involve the use of the relationship of weighted classified assets to Tier 1 capital funds and total classifications to total capital funds. Accordingly, consolidated asset quality could be based on the relationship of aggregate weighted classified assets of the parent company, bank subsidiary(ies) and nonbank subsidiary(ies), to Tier 1 capital.

However, a problem encountered when viewing asset quality on a consolidated basis is the fact that in multi-bank holding companies there is usually a large timing difference between the dates of examinations of the banking subsidiaries. Therefore, the aggregating of classified bank assets from reports prepared at different times, reduces the currentness and validity of conclusions drawn. This problem can only be eliminated by using common examination and inspection dates which are not generally available.

Despite the shortcoming of using classification information from different dates, an examiner may determine that there is a sufficient measure of validity in using the data and may present an analysis based on consolidated weighted classifications. For example, if there are a small number of bank subsidiaries and if the examination dates are near a common point in time, timing differences may be inconsequential. Or, if a review of several years of a bank's examinations reveals a relatively constant or stable level of classifications, then the timing of the most recent examination would not invalidate use of the analytical tool. As such, the technique may be employed when circumstances permit.

Other factors to be considered in determining asset quality include the levels of nonaccrual and renegotiated loans, other real estate owned and past due loans. While these assets may not be subject to classification, they usually represent former or emerging problem loans. Moreover, in the aggregate, they may represent a significant proportion of the asset portfolio. If such is the case, they should be taken into consideration when the examiner determines his overall rating of asset quality.

It is difficult to rely on the adequacy of consolidated reserves because they are ''fractured'' and protect portfolios in different organizations and may not be interchangeable or transferable. The reserve of each entity in the corporate structure must be reviewed or analyzed individually. For example, if consolidated reserves appear inadequate, there is no consolidated reserve account per se that could be increased to adequate proportions. Consequently, the inadequacy would have to be identified at the parent or subsidiary level. Conversely, if consolidated reserves appear to adequately cover the aggregate of all ''loss'' and a certain portion of ''doubtful,'' it does not insure that all subsidiaries have adequate reserves. Nevertheless, despite the shortcomings of using consolidated reserves, the analyst should not hesitate to calculate and present a measure of the relationship of consolidated reserves to consolidated loans.

4060.8.1 ASSET-BACKED COMMERCIAL PAPER PROGRAMS

Asset-backed commercial paper (ABCP) programs provide a means for corporations to obtain funding by selling or securitizing pools of homogenous assets (for example, trade receivables) to special-purpose entities (SPEs/ABCP programs). The ABCP program raises funds for purchase of these assets by issuing commercial paper into the marketplace. The commercial-paper investors are protected by structural enhancements provided by the seller (for example, overcollateralization, spread accounts, or early-amortization triggers) and by credit enhancements (for example, subordinated loans or guarantees) provided by banking organization sponsors of the ABCP program and by other third parties. In addition, liquidity facilities are also present to ensure the rapid and orderly repayment of commercial paper should cash-flow difficulties emerge. ABCP programs are nominally capitalized SPEs that issue commercial paper. A sponsoring banking organization establishes the ABCP program but usually does not own the conduit's equity, which is often held by unaffiliated third-party management companies that specialize in owning such entities, and are structured to be bankruptcy remote.

Typical Structure

ABCP programs are funding vehicles that banking organizations and other intermediaries establish to provide an alternative source of funding to themselves or their customers. In contrast to term securitizations, which tend to be amortizing, ABCP programs are ongoing entities that usually issue new commercial paper to repay maturing commercial paper. The majority of ABCP programs in the capital markets are established and managed by major international commercial banking organizations. As with traditional commercial paper, which has a maximum maturity of 270 days, ABCP is short-term debt that may either pay interest or be issued at a discount (see figure 1).

Types of ABCP Programs

Multi-seller programs generally provide working capital financing by purchasing or advancing against receivables generated by multiple corporate clients of the sponsoring banking organizations. These programs are generally well diversified across both sellers and asset types.

Single-seller programs are generally established to fund one or more types of assets originated by a single seller. The lack of diversification is generally compensated for by increased program-wide credit enhancement.

Loan-backed programs fund direct loans to corporate customers of the ABCP program's sponsoring banking organization. These loans are generally closely managed by the banking organization and have a variety of covenants designed to reduce credit risk.

Securities-arbitrage programs invest in securities that generally are rated AA- or higher. They generally have no additional credit enhancement at the seller/transaction level because the securities are highly rated. These programs are typically well diversified across security types. The arbitrage is mainly due to the difference between the yield on the securities and the funding cost of the commercial paper.

Structured investment vehicles (SIVs) are a form of a securities-arbitrage program. These ABCP programs invest in securities typically rated AA- or higher. SIVs operate on a market-value basis similar to market-value collateralized debt obligation in that they must maintain a dynamic overcollateralization ratio determined by analysis of the potential price volatility on securities held in the portfolio. SIVs are monitored daily and must meet strict liquidity, capitalization, leverage, and concentration guidelines established by the rating agencies.

Key Parties and Roles

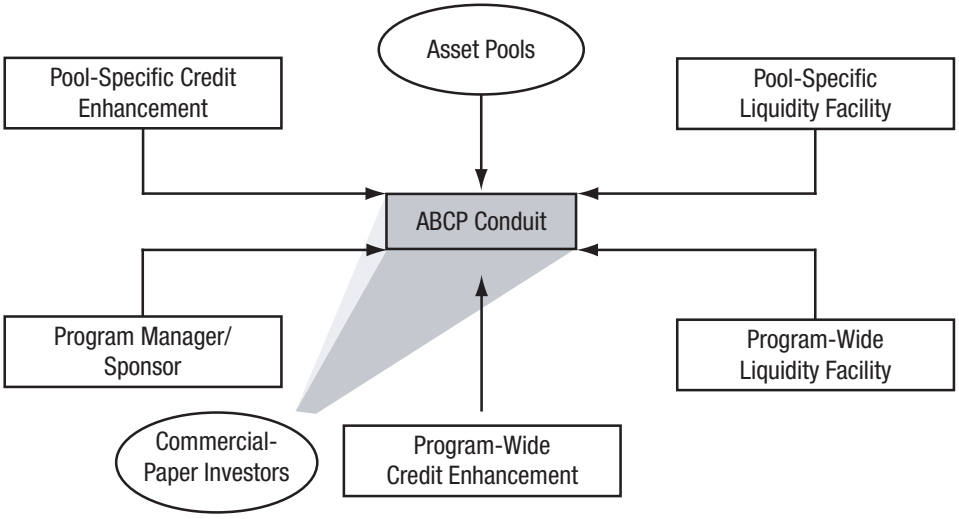
Key parties for an ABCP program include the following:

- program management/administrators
- credit-enhancement providers
- liquidity-facility providers
- seller/servicers
- commercial paper investors

Program Management

The sponsor of an ABCP program initiates the creation of the program but typically does not own the equity of the ABCP program, which is

Figure 1. Asset-backed commercial paper structure



provided by unaffiliated third-party investors. Despite not owning the equity of the ABCP program, sponsors usually retain a financial stake in the program by providing credit enhancement, liquidity support, or both, and they play an active role in managing the program. Sponsors typically earn fees—such as credit-enhancement, liquidity-facility, and program-management fees—for services provided to their ABCP programs.

Typically, an ABCP program makes arrangements with various agents/servicers to conduct the administration and daily operation of the ABCP program. This includes such activities as purchasing and selling assets, maintaining operating accounts, and monitoring the ongoing performance of each transaction. The sponsor is also actively engaged in the management of the ABCP program, including underwriting the assets purchased by the ABCP program and the type/level of credit enhancements provided to the ABCP program.

Credit-Enhancement Providers

The sponsoring banking organization typically provides pool-specific and program-wide backup liquidity facilities, and program-wide credit enhancements, all of which are usually unrated (pool-specific credit enhancement, such as over-collateralization, is provided by the seller of the assets). These enhancements are fundamental for obtaining high investment-grade ratings on the commercial paper issued to the market by the ABCP program. Seller-provided credit enhancement may exist in various forms and is generally sized based on the type and credit quality of the underlying assets as well as the quality and financial strength of seller/servicers. Higher-quality assets may only need partial support to achieve a satisfactory rating for the commercial paper. Lower-quality assets may need full support.

Liquidity-Facility Providers

The sponsoring banking organization and in some cases, unaffiliated third parties, provide pool-specific or program-wide liquidity facilities. These backup liquidity facilities ensure the timely repayment of commercial paper under certain conditions, such as when financial market disruptions or cash-flow timing mismatches were to occur, but generally not under conditions associated with the credit deterioration of the underlying assets or the seller/servicer to the extent that such deterioration is beyond what is permitted under the related asset-quality test.

Commercial Paper Investors

Commercial paper investors are typically institutional investors, such as pension funds, money market mutual funds, bank trust departments, foreign banks, and investment companies. Com-

mercial paper maturities range from one day to 270 days, but most frequently are issued for 30 days or less. There is a limited secondary market for commercial paper since issuers can closely match the maturity of the paper to the investors' needs. Commercial paper investors are generally repaid from the reissuance of new commercial paper or from cash flows stemming from the underlying asset pools purchased by the program. In addition, to ensure timely repayment in the event that new commercial paper cannot be issued or if anticipated cash flows from the underlying assets do not occur, ABCP programs utilize backup liquidity facilities. Furthermore, the banking organization can purchase the ABCP from the conduit if the commercial paper cannot be issued. Pool-specific and program-wide credit enhancements also protect commercial paper investors from deterioration of the underlying asset pools.

4060.8.2 THE LOSS WATERFALL

The loss waterfall diagram (see figure 2) for the exposures of a typical ABCP program generally has four legally distinct layers. However, most legal documents do not specify which form of credit or liquidity enhancement is in a priority position after pool-specific credit enhancement is exhausted due to defaults. For example, after becoming aware of weakness in the seller/servicer or in asset performance, an ABCP program sponsor may purchase assets out of the conduit using pool-specific liquidity. Liquidity agreements must be subject to a valid asset-quality test that prevents the purchase of defaulted or highly delinquent assets. Liquidity facilities that are not limited by such an asset-quality test are to be viewed as credit enhancement and are subject to the risk-based capital requirements applicable to direct-credit substitutes.

Pool-Specific Credit Enhancement

The form and size of credit enhancement for each particular asset pool is dependent upon the nature and quality of the asset pool and the seller/servicer's risk profile. In determining the level of credit enhancement, consideration is given to the seller/servicer's financial strength, quality as a servicer, obligor concentrations, and obligor credit quality, as well as the historic performance of the asset pool. Credit enhancement is generally sized to cover a multiple level of historical losses and dilution for the particular asset pool. Pool-specific credit enhancement can take several forms, including overcollateralization, cash reserves, seller/servicer guarantees (for only highly rated seller/servicers), and subordination. Credit enhancement can either be dynamic (that is, increases as the asset pool's performance deteriorates) or static (that is, fixed percentage). Pool-specific credit enhancement is generally provided by the seller/servicer (or carved out of the asset pool in the case of overcollateralization) but may be provided by other third parties.

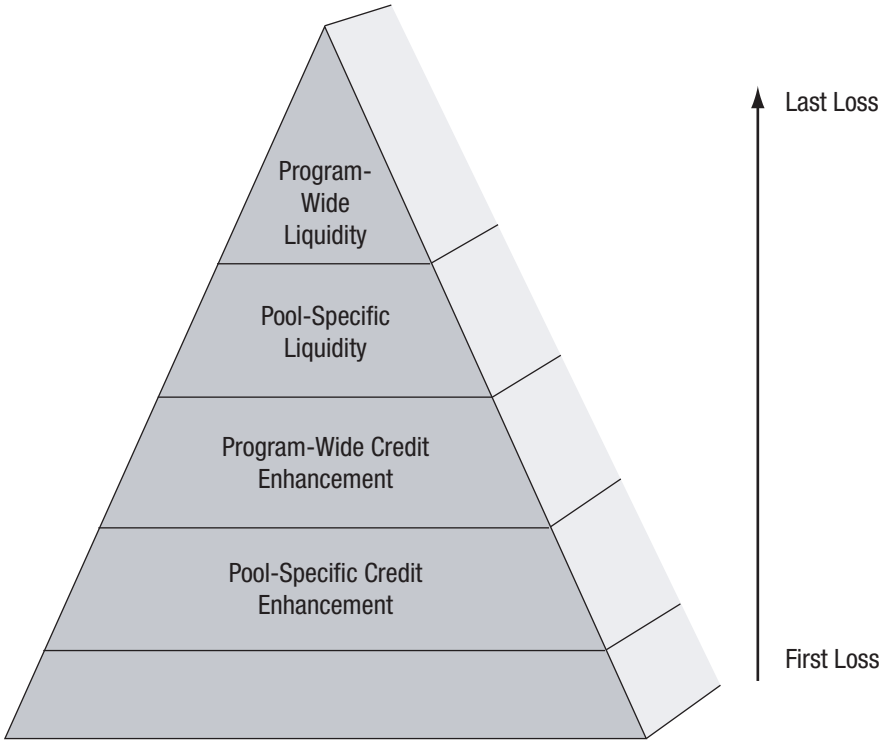
The ABCP program sponsor or administrator will generally set strict eligibility requirements for the receivables to be included in the purchased asset pool. For example, receivable eligibility requirements will establish minimum credit ratings or credit scores for the obligors and the maximum number of days the receivable can be past due.

Usually the purchased asset pools are structured (credit-enhanced) to achieve a credit-quality equivalent of investment grade (that is, BBB or higher). The sponsoring banking organization will typically utilize established rating agency criteria and structuring methodologies to achieve the desired internal rating level. In certain instances, such as when ABCP programs purchase ABS, the pool-specific credit enhancement is already built into the purchased ABS and is reflected in the security's credit rating. The internal rating on the pool-specific liquidity facility provided to support the purchased asset pool will reflect the inclusion of the pool-specific credit enhancement and other structuring protections.

Program-Wide Credit Enhancement

The second level of contractual credit protection is the program-wide credit enhancement, which may take the form of an irrevocable loan facility, a standby letter of credit, a surety bond from a monoline insurer, or an issuance of subordinated debt. Program-wide credit enhancement protects commercial paper investors if one or more of the underlying transactions exhaust the pool-specific credit enhancement and other structural protections. The sponsoring banking organization or third-party guarantors are providers of this type of credit protection. The program-wide credit enhancement is generally sized by

Figure 2. The Loss Waterfall



the rating agencies to cover the potential of multiple defaults in the underlying portfolio of transactions within ABCP conduits and takes into account concentration risk among seller/servicers and industry sectors.

Pool-Specific Liquidity

Pool-specific liquidity facilities are an important structural feature in ABCP programs because they ensure timely payment on the issued commercial paper by smoothing timing differences in the payment of interest and principal on the pooled assets and ensuring payments in the event of market disruptions. The types of liquidity facilities may differ among various ABCP programs and may even differ among asset pools purchased by a single ABCP program. For instance, liquidity facilities may be structured either in the form of (1) an asset-purchase agreement, which provides liquidity to the ABCP program by purchasing nondefaulted assets from a specific asset pool, or (2) a loan to the ABCP program, which is repaid solely by the cash flows from the underlying assets.[1] Some older ABCP programs may have both pool-specific liquidity and program-wide liquidity coverage, while more-recent ABCP programs tend to utilize only pool-specific facilities. Typically, the seller-provided credit enhancement continues to provide credit protection on an asset pool that is purchased by a liquidity banking organization so that the institution is protected against credit losses that may arise due to subsequent deterioration of the pool.

Pool-specific liquidity, when drawn prior to the ABCP program's credit enhancements, is subject to the credit risk of the underlying asset pool. However, the liquidity facility does not provide direct credit enhancement to the commercial paper holders. Thus, the pool-specific liquidity facility generally is in an economic second-loss position after the seller-provided credit enhancements and prior to the program-

1. Direct-liquidity loans to an ABCP program may be termed a *commissioning agreement* (most likely in a foreign bank program) and may share in the security interest in the underlying assets when commercial paper ceases to be issued due to deterioration of the asset pool.

wide credit enhancement even when the legal documents state that the program-wide enhancement would absorb losses prior to the pool-specific liquidity facilities. This is because the sponsor of the ABCP program would most likely manage the asset pools in such a way that deteriorating portfolios or assets would be put to the liquidity banking organizations prior to any defaults that would require a draw against the program-wide credit enhancement.[2] While the liquidity banking organization is exposed to the credit risk of the underlying asset pool, the risk is mitigated by the seller-provided credit enhancement and the asset-quality test.[3] At the time that the asset pool is put to the liquidity banking organization, the facility is usually fully drawn because the entire amount of the pool that qualifies under the asset-quality test is purchased by the banking organization. However, with respect to revolving transactions (such as credit card securitizations) it is possible to average less than 100 percent of the commitment.

Program-Wide Liquidity

The senior-most position in the waterfall, program-wide liquidity, is provided in an amount sufficient to support that portion of the face amount of all the commercial paper that is issued by the ABCP program that is necessary to achieve the desired external rating on the issued paper. In some cases, a liquidity banking organization that extends a direct liquidity loan to an ABCP program may be able to access the program-wide credit enhancement to cover losses while funding the underlying asset pool.

2. In fact, according to the contractual provisions of some conduits, a certain level of draws on the program-wide credit enhancement is a condition for unwinding the conduit program, which means that this enhancement is never meant to be used.

3. An asset-quality test or liquidity-funding formula determines how much funding the liquidity banking organization will extend to the conduit based on the quality of the underlying asset pool at the time of the draw. Typically, liquidity banking organizations will fund against the conduit's purchase price of the asset pool less the amount of defaulted assets in the pool.

WHAT'S NEW IN THIS REVISED SECTION

The guidance in this section does not apply to U.S. bank holding companies (BHCs) or intermediate holding companies of foreign banking organizations with $50 billion or more in total consolidated assets. See SR letter 15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms" (section 4063.0.1) and SR letter 15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms" (section 4065.0.1) for more information. In addition, inactive guidance references in this section have been updated.

This supervisory guidance provides direction to supervisory staff and BHCs on the declaration and payment of dividends,[1] capital redemptions, and capital repurchases by BHCs in the context of their capital planning processes. The guidance establishes Federal Reserve expectations that a BHC will inform and consult with Federal Reserve supervisory staff sufficiently in advance of (1) declaring and paying a dividend that could raise safety-and-soundness concerns (e.g., declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid); (2) redeeming or repurchasing regulatory capital instruments when the BHC is experiencing financial weaknesses; or (3) redeeming or repurchasing common stock or perpetual preferred stock that would result in a net reduction as of the end of a quarter in the amount of such equity instruments outstanding compared with the beginning of the quarter in which the redemption or repurchase occurred.

While these principles (as stated in SR-09-4) are applicable to all BHCs, they are especially relevant for BHCs that are experiencing financial difficulties and/or receiving public funds. Supervisory staff should document their analyses of the issues discussed below and include such documentation in workpapers related to supervisory activities.[2] Such documentation not only provides a basis for constructive dialogue with an organization's management, but also supports current and future supervisory actions or initiatives. Reserve Bank and Board staff will develop a supervisory response in all instances where concerns regarding depletion of capital arise for a BHC that is experiencing financial difficulties.[3]

4060.9.1 REVIEW OF CAPITAL ADEQUACY MANAGEMENT

A fundamental principle underlying the Federal Reserve's supervision and regulation of BHCs is that a BHC should serve as a source of managerial and financial strength to its subsidiary banks.[4] Consistent with this premise, the Federal Reserve expects an organization to hold capital commensurate with its overall risk profile. The risk-based capital rules state that the capital requirements are minimum standards based primarily on broad credit-risk considerations. The risk-based capital ratios do not take explicit account of the quality of individual asset portfolios or the range of other types of risk to which banking organizations may be exposed (e.g., interest-rate, liquidity, market, and operational risks). For this reason, banking organizations are generally expected to operate with capital positions well above the minimum ratios, with the amount of capital held by a banking organization corresponding to its broad risk exposure. Because an overall assessment of capital adequacy must take into account factors

1. The term "dividends" as used in SR-09-4 refers to dividends on common stock and preferred stock, as well as dividends or interest on the subordinated notes underlying trust preferred securities and other tier 1 capital instruments, in cash or other value (collectively, "dividends"). Stock dividends (i.e., dividends in the form of common stock) are excluded. The priority of payment of dividends is based on the level of seniority of the instrument, which is established by contract between an issuer and its investors.

2. As discussed in SR-13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less," risk-focused supervision of certain noncomplex BHCs with consolidated assets of less than $1 billion relies extensively on off-site monitoring, surveillance, and the assessments of primary banking supervisors of holding company subsidiaries. For such BHCs, supervisory staff generally will be able to rely to a large extent on off-site surveillance and monitoring activities to identify potential supervisory issues related to capital adequacy as discussed in SR-09-4. Expectations for related documentation are likewise commensurate with the size and complexity of the BHC.

3. Notwithstanding the general guidance in SR-09-4, the Federal Reserve may establish more stringent institution-specific requirements under its supervisory or enforcement authority. To the extent those requirements are more stringent than this guidance, those requirements supersede this guidance.

4. See 12 CFR 225.4(a)(1).

beyond those reflected in the minimum regulatory capital ratios, supervisory assessments of capital adequacy may differ significantly from conclusions based solely on the level of an organization's risk-based capital ratio.

Consequently, an organization's internal process for assessing capital adequacy should reflect a full understanding of its risks and ensure that it holds capital corresponding to those risks to maintain overall capital adequacy. Key among these risks is the risk of illiquidity, particularly that a perceived lack of financial strength (e.g., a capital shortfall relative to potential losses in a stress scenario) may lead investors and counterparties to withhold funds or otherwise cease engaging in business with the organization. This is particularly important for a banking organization that is a core clearing and settlement organization or that has a significant presence in critical financial markets; such an organization is expected to have especially rigorous and effective internal processes for assessing capital adequacy.[5]

In addition to evaluating the appropriateness of a BHC's capital level given its overall risk profile, supervisory staff should focus on the quality of a BHC's capital and trends in its capital composition. In this regard, the Board's risk-based capital rules state that voting common stockholders' equity, which is the most desirable capital element from a supervisory standpoint, generally should be the dominant element within tier 1 capital, and that banking organizations should avoid overreliance on noncommon-equity capital elements.[6] Accordingly, a BHC should place primary reliance on its common equity, followed by perpetual preferred stock, which is included in equity under generally accepted accounting principles (GAAP) and absorbs losses on a going-concern basis (that is, helps a BHC avoid insolvency despite losses on its assets). Tax-deductible hybrid capital instruments, such as trust preferred securities, provide a limited supplement within tier 1 capital to a BHC's common stock and preferred stock.

In assessing a BHC's capital adequacy, supervisory staff should evaluate the comprehensiveness and effectiveness of management's capital planning. An effective capital planning process requires a banking organization to assess the risks to which it is exposed and its processes for managing and mitigating those risks, evaluate its capital adequacy relative to its risks, and consider the potential impact on its earnings and capital base from current and prospective economic conditions. A BHC's capital planning process should be commensurate with the BHC's size, complexity, and risk profile[7] and should entail consideration of a variety of factors. The supervisory guidance within SR-09-4 is not intended to describe comprehensively all elements of a BHC's capital planning process, but rather to focus on those factors that a BHC's board of directors should take into account when considering the payment of dividends, stock redemptions, or stock repurchases. Factors that the BHC's board of directors should consider include the following:

1. overall asset quality, potential need to increase reserves and write down assets, and concentrations of credit;
2. potential for unanticipated losses and declines in asset values;
3. implicit and explicit liquidity and credit commitments, including off-balance-sheet and contingent liabilities;
4. quality and level of current and prospective earnings, including earnings capacity under a number of plausible economic scenarios;
5. current and prospective cash flow and liquidity;
6. ability to serve as an ongoing source of financial and managerial strength to depository institution subsidiaries insured by the Federal Deposit Insurance Corporation, including the extent of double leverage[8] and the condition of subsidiary depository institutions;

5. As discussed in SR-03-9, "Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System," core clearing and settlement organizations are defined as large-value payment system operators and market utilities that provide critical clearing and settlement services for critical financial markets. The term also includes firms that provide clearing and settlement services that are integral to a critical financial market (i.e., their market share is significant enough to present systemic risk in the event of their sudden failure to carry on those activities because there are no immediately viable alternatives). Firms that play significant roles in critical financial markets are those that consistently clear or settle at least five percent of the value of transactions in a critical market.

6. See 12 CFR 225, appendix A, section II.A.1.c.(3).

7. Large BHCs and others with complex risk profiles should have in place robust internal capital adequacy assessment processes. (See sections 4063.0.1 and 4065.0.1 of this manual for more information.) BHCs that use the advanced approaches in the risk-based capital framework may be subject to further requirements in this regard.

8. Double leverage refers to situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity. In this regard, supervisory staff should also consider the impact of any potential overreliance a BHC may have on dividends received from subsidiaries as a source of payment for its liabilities.

7. other risks that affect the BHC's financial condition and are not fully captured in regulatory capital calculations;
8. level, composition, and quality of capital; and
9. ability to raise additional equity capital in prevailing market and economic conditions.

Supervisory findings in the areas discussed in SR-09-4 should be incorporated into the assessment of the "Capital" subcomponent for the BHC's "Financial Condition" rating component in the RFI (Risk Management, Financial Condition, and Impact) rating[9] assigned to a BHC. See section 4060.9.3 for information that supervisory staff should seek from BHCs in developing this assessment.

4060.9.1.1 Dividends in Cash or Other Value

Crucial to any capital plan are the effects on a BHC's financial condition of the payment of dividends on common stock[10] and other tier 1 capital instruments, as described previously in footnote 1. Consistent with the Board's November 14, 1985, "Policy Statement on the Payment of Cash Dividends" (see section 2020.5, or the *FRRS* at 4-185), a banking organization should have comprehensive policies on dividend payments that clearly articulate the organization's objectives and approaches for maintaining a strong capital position and achieving the objectives of the policy statement. These policies should take into account the potential drain on a BHC's resources posed by the payment not just of cash dividends, but also of non-cash dividends, which can take many different forms (e.g., the distribution of assets to shareholders, particularly insiders, or the assumption or guarantee of certain shareholders' liabilities), other than those in the form of common stock, which generally do not raise supervisory concerns.

When a BHC's board of directors is deciding on the level of dividends to declare,[11] it should consider, among other things, the factors discussed above in 4060.9.1. It is particularly important for a banking organization's board of directors to ensure that the dividend level is prudent relative to the organization's financial position and is not based on overly optimistic earnings scenarios. Supervisory staff should engage in discussions with a BHC on its overall dividend policies and practices as part of the ongoing supervisory assessment of capital adequacy. Moreover, because the period between declaration of a dividend and the payment date may be as much as 60 days, in making a declaration, the board of directors should consider any potential events that may occur before the payment date that could affect its ability to pay while still maintaining a strong financial position.[12]

While many organizations place great importance on consistently paying dividends, a board of directors should strongly consider, after careful analysis of the factors described above under "Review of Capital Adequacy Management" (see section 4060.9.1), reducing, deferring, or eliminating dividends when the quantity and quality of the BHC's earnings have declined or the BHC is experiencing other financial problems, or when the macroeconomic outlook for the BHC's primary profit centers has deteriorated.[13] As a general matter, the board of directors of a BHC should inform the Federal Reserve and should eliminate, defer, or significantly reduce the BHC's dividends if

1. The BHC's net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;
2. The BHC's prospective rate of earnings retention is not consistent with the BHC's capital needs and overall current and prospective financial condition; or
3. The BHC will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

Failure to do so could result in a supervisory finding that the organization is operating in an unsafe and unsound manner.

Moreover, a BHC should inform the Federal

9. See SR-04-18, "Bank Holding Company Rating System" and section 4070.0.

10. This includes dividends paid on common stock by BHCs qualifying under Subchapter S of Chapter 1 of the Internal Revenue Code. For regulatory and supervisory purposes, such dividends are treated the same as those paid by other BHCs.

11. As a general matter, the declaration of a dividend to shareholders establishes a legal obligation to pay that dividend and is recorded as a liability on the balance sheet.

12. Payments on trust preferred securities are not declared. Rather, the BHC must make a decision not to make a payment; typically, this decision must be made 15 days before payment is due.

13. Contractual arrangements typically dictate that a banking organization may not defer dividends on senior instruments (e.g., preferred stock) unless dividends have been fully deferred on more junior instruments (e.g., common stock).

Reserve reasonably in advance of declaring or paying a dividend that exceeds earnings for the period (e.g., quarter) for which the dividend is being paid or that could result in a material adverse change to the organization's capital structure. Declaring or paying a dividend in either circumstance could raise supervisory concerns. Likewise, a BHC should apprise the Federal Reserve reasonably in advance of declaring any material increase in its common stock dividend to ensure that it does not raise safety-and-soundness concerns.

4060.9.1.2 Stock Redemptions and Repurchases

It is an essential principle of safety and soundness that a banking organization's redemption of instruments included in regulatory capital and repurchases of common stock, preferred stock, and other regulatory capital instruments from investors be consistent with the organization's current and prospective capital needs. In assessing such needs, the board of directors and management of a BHC should consider the factors discussed above in section 4060.9.1.

Federal Reserve supervisory staff should continue exercising their supervisory oversight and regulatory authority in evaluating BHCs' capital planning processes, as discussed above, and consulting with BHCs regarding their proposed redemptions and repurchases of common stock, preferred stock, and other regulatory capital instruments. There are explicit regulatory requirements for Federal Reserve review of such transactions in several situations:

1. Certain non-exempted BHCs are required under section 225.4(b)(1) of Regulation Y to notify the Federal Reserve of actions that would reduce a BHC's consolidated net worth by 10 percent or more.[14]
2. Under the Board's risk-based capital rule for BHCs, most instruments included in tier 1 capital[15] with features permitting redemption at the option of the issuing BHC (e.g., perpetual preferred stock and trust preferred securities) may qualify as regulatory capital only if redemption is subject to prior Federal Reserve approval.[16]
3. The risk-based capital rule directs BHCs to consult with the Federal Reserve before redeeming any equity or other capital instrument included in tier 1 or tier 2 capital prior to stated maturity, if such redemption could have a material effect on the level or composition of the organization's capital base.[17]

In addition, Federal Reserve supervisory staff should exercise the above regulatory authorities, as well as the Federal Reserve's general supervisory and enforcement authority, to prevent a BHC from repurchasing its common stock, preferred stock, trust preferred securities, and other regulatory capital instruments in the market, if such action would be inconsistent with the BHC's prospective capital needs and continued safe and sound operation. BHCs experiencing financial weaknesses, or that are at significant risk of developing financial weaknesses, should consult with the appropriate Federal Reserve supervisory staff before redeeming or repurchasing common stock or other regulatory capital instruments for cash or other valuable consideration. Similarly, any BHC considering expansion, either through acquisitions or through new activities, also generally should consult with the appropriate Federal Reserve supervisory staff before redeeming or repurchasing common stock or other regulatory capital instruments for cash or other valuable consideration.

In evaluating the appropriateness of a BHC's proposed redemption or repurchase of capital instruments, Federal Reserve supervisory staffs

14. Section 225.4(b)(1) of Regulation Y requires that a BHC that is not well capitalized or well managed, or that is subject to any unresolved supervisory issues, provide prior notice to the Federal Reserve for any repurchase or redemption of its equity securities for cash or other value that would reduce by 10 percent or more the BHC's consolidated net worth aggregated over the preceding 12-month period. All repurchases and redemptions within a 12-month period are aggregated for the application of this rule, regardless of any other approval or supervisory consultation process that was followed by the BHC with regard to its repurchases and redemptions of equity securities.

15. See 12 CFR 217.

16. Unlike the process noted above for transactions requiring notification of the Federal Reserve under Regulation Y, such approvals and the consultative process for other repurchases and redemptions are part of the Federal Reserve's general supervisory processes and do not, therefore, require formal applications.

17. See 12 CFR 225, appendix A, section II.(iii). Such consultation by small BHCs subject to the Board's Small Bank Holding Company and Savings and Loan Holding Company Policy Statement ("Small BHC Policy Statement"; see Regulation Y: 12 CFR 225, appendix C), however, is only required for the redemption of instruments included in equity as defined under GAAP—such as common and perpetual preferred stock—and not for other instruments included in regulatory capital solely under the risk-based capital rule.

are directed to consider:

1. the potential losses that a BHC may suffer from the prospective need to increase reserves and write down assets from continued asset deterioration and
2. the BHC's ability to raise additional common stock and other tier 1 capital to replace capital instruments that are redeemed or repurchased.

In addition, supervisory staff should consider the potential negative effects on capital of a BHC

1. replacing common stock with lower-quality forms of regulatory capital (e.g., hybrids or subordinated debt) or
2. redeeming or repurchasing equity and other capital instruments from investors, including selective repurchases or redemptions from insiders, with cash or other value that could be better used to strengthen the BHC's regulatory capital base or its overall financial condition.

Furthermore, to facilitate such supervisory oversight, a BHC should inform Federal Reserve supervisory staff of a redemption or repurchase[18] of common stock or perpetual preferred stock for cash or other value resulting in a net reduction of a BHC's outstanding amount of common stock or perpetual preferred stock below the amount of such capital instrument outstanding at the beginning of the quarter in which the redemption or repurchase occurs. It is not necessary to inform supervisory staff pursuant to SR-09-4 when reductions in a BHC's tier 1 capital during a quarter will result from other causes, such as a reduction of the BHC's retained earnings due to negative earnings.

BHCs should advise Federal Reserve supervisory staff sufficiently in advance of such redemptions and repurchases to provide reasonable opportunity for supervisory review and possible objection should Federal Reserve supervisory staff determine a transaction raises safety-and-soundness concerns. When informing Federal Reserve supervisory staff of redemptions and repurchases, including requests for approval of redemptions under the risk-based capital rule as discussed above, a BHC may provide information either for a proposed transaction or for a number of transactions within a given quarter on its tier 1 capital composition. Such information should include the dollar amount and percentage breakdown of the BHC's tier 1 capital components (that is, common equity, perpetual preferred stock, and other tier 1 capital instruments), as well as its regulatory capital ratios, at the beginning of the previous quarter and most recent four-quarter period, as well as pro forma changes to its capital composition and ratios resulting from its proposed redemptions or repurchases.

18. Redemptions of most instruments (e.g., preferred stock or trust preferred securities) included in regulatory capital require Federal Reserve approval under the risk-based capital rule, but such redemptions by small BHCs are not required under the small BHC policy statement.

4060.9.2 INSPECTION OBJECTIVES

1. To analyze and document issues discussed above that are present at the BHC and include such documentation in the inspection's workpapers, including those related to supervisory activities.
2. To evaluate the quality of a BHC's capital and the trends in its capital composition.
3. To determine if the BHC has informed and consulted with Federal Reserve supervisory staff sufficiently in advance of
   a. declaring and paying a dividend that could raise safety-and-soundness concerns (for example, declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid);
   b. redeeming or repurchasing regulatory capital instruments when the BHC is experiencing financial weaknesses; or
   c. redeeming or repurchasing any common stock or perpetual preferred stock that would result in a net reduction as of the end of a quarter in the amount of such equity instruments outstanding compared with the beginning of the quarter in which the redemption or repurchase occurred.
4. To evaluate the comprehensiveness and effectiveness of management's capital planning.

4060.9.3 INSPECTION PROCEDURES[19]

Capital Planning

1. Determine if the existing capital level is

19. These procedures are not intended to encompass comprehensively a BHC's capital planning, and are focused on information that may be useful in reviewing the impact of dividends and repurchases or redemptions on capital adequacy. More comprehensive inspection procedures for assessing capital adequacy of BHCs are available in section 4060.3.11.

adequate for the BHC's risk profile when considering the following items:
   a. the level and trend of adversely classified assets;
   b. the adequacy of the allowance for loan and lease losses;
   c. the volume of charged-off loans and recoveries;
   d. the balance sheet structure and liquidity needs;
   e. the level and type of concentrations;
   f. compliance with state and federal capital requirements; and
   g. composition of elements of capital.
2. Determine if earnings performance enables the BHC to fund its growth, remain competitive in the marketplace, and support its overall risk profile. Consider the level and trend of equity capital to total assets as well as asset and equity growth rates.
   a. Review the current level of the provision for loan and lease losses.
   b. Review whether the bank is relying on core earnings or income from nonrecurring events.
   c. Determine if dividends are excessive when compared to current earnings or potential capital needs, or could otherwise result in a material adverse change to the organization's capital structure.
3. Determine the effect of current capital levels on the future viability of the BHC and its subsidiary depository institutions.
   a. Assess management's ability to reverse deteriorating trends and to augment capital through earnings.
   b. Assess the ability of the BHC to raise capital from existing shareholders, issue new capital instruments, or access alternative sources of capital.
   c. Assess the reasonableness of capital plans.

Dividend in Cash or Other Value

4. Determine whether the BHC has a comprehensive dividend policy at the holding company and for each of its subsidiaries that help it in its capital planning processes.
5. Assess whether provisions contained in the policies and practices conform to the guidance outlined in the Federal Reserve Board's 1985 dividend policy statement.
6. Determine whether, and if so, how, the BHC has changed in any way its dividend policy to accommodate the current economic environment.
7. Assess whether dividends in cash or other value are consistent with the BHC's current and prospective capital needs, including likely future reserve increases and asset write-downs, as well as the feasibility in the near term of the BHC raising additional capital in the market.

Stock Repurchases and Redemptions

8. Review schedule HI-A (Changes in Equity Capital) of the BHC's FR Y-9C report for any changes in components of capital.
9. Review any correspondence from the BHC to the Federal Reserve that indicates any plans to initiate common or preferred stock repurchases or redemptions in the foreseeable future.
10. Review the BHC's strategic plan for any mention of stock repurchases or redemptions.
11. Review the BHC's capital plan for any mention of stock repurchases or redemptions.
12. Discuss with management whether they are in any other way contemplating stock repurchases or redemptions, and if so, what the likely magnitude and timeline of such repurchases will be.
13. Assess whether such repurchases or redemptions foster sound capital positions, especially if the organization is (or could be) experiencing financial weakness.

4060.9.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
BHC should serve as a source of financial and managerial strength to its subsidiaries		225.4(a)(1)		
Purchase or redemption by BHC of its own securities		225.4(b)(1)		
Voting common stockholders' equity should be the dominant form of tier 1 capital		225, appendix A, section II.A.1.c.(3)		
Directed advance consultation with Federal Reserve if a redemption of capital prior to stated maturity would materially affect the level or composition of BHC's capital base		225, appendix A, section II.iii		
Board policy on payment of cash dividends			4-877	
Small BHC Policy Statement		225, appendix C		

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

WHAT'S NEW IN THIS REVISED SECTION

This section is being revised to include the March 1, 2016, "Interagency Guidance on Funds Transfer Pricing Related to Funding Contingency Risks." The guidance was issued to address weaknesses observed in large financial institutions' funds transfer pricing (FTP) practices related to funding risk (including interest rate and liquidity components) and contingent liquidity risk. The interagency guidance builds on the principles of sound liquidity risk management that are described below. FTP is an important tool for managing a firm's balance sheet structure and measuring risk-adjusted profitability. By allocating funding and contingent liquidity risks to business lines, products, and activities within a firm, FTP influences the volume and terms of new business and ongoing portfolio composition. If done effectively, FTP promotes more resilient, sustainable business models. (Refer to SR-16-03.)

The March 17, 2010, interagency policy statement on "Funding and Liquidity Risk Management" targets funding and risk-management principles for insured depository institutions, including state member banks. The basic principles presented in this policy statement also apply to bank holding companies (BHCs). The Federal Reserve expects supervised financial institutions and BHCs to manage liquidity risk using processes and systems that are commensurate with their complexity, risk profile, and scope of operations. Liquidity risk-management processes and plans should be well documented and available for supervisory review. (See SR-10-6 and its attachment.)

BHCs are expected to manage and control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. Appropriate liquidity risk management is especially important for BHCs since liquidity difficulties can easily spread to both depository and non-depository subsidiaries, particularly in cases of similarly named companies where customers may not always understand the legal distinctions between the holding company and subsidiaries. For this reason, BHCs should ensure that liquidity is sufficient at all levels of the organization to fully accommodate funding needs during periods of stress.

Liquidity risk-management processes and funding programs should take into full account the institution's lending, investment, and other activities and should ensure that adequate liquidity is maintained at the parent holding company and each of its subsidiaries. These processes and programs should fully incorporate real and potential constraints, including legal and regulatory restrictions, on the transfer of funds among subsidiaries and between subsidiaries and the parent holding company. BHC liquidity should be maintained at levels sufficient to fund holding company and affiliate operations for an extended period of time in a stressed environment when access to normal funding sources are disrupted, without having a negative impact on insured depository institution subsidiaries.

Material nonbank subsidiaries, such as broker-dealers, are expected to have liquidity-management processes and funding programs that reflect the principles outlined in the interagency policy statement guidance below (section 4066.0.1) and are consistent with the subsidiaries' complexity, risk profile, and scope of operations. A nonbank subsidiary that directly accesses market sources of funding and/or manages specific funding programs should pay particular attention to

- maintaining sufficient liquidity, cash flow, and capital strength to service its debt obligations and cover fixed charges;
- assessing the potential that funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institutions; and
- ensuring the adequacy of policies and practices that address the stability of funding and integrity of the institution's liquidity risk profile as evidenced by funding mismatches and the degree of dependence on potentially volatile sources of short-term funding.

For guidance on liquidity risk-measurement techniques, see section 4020.1, Appendix 1, of the *Commercial Bank Examination Manual*. For the supervisory plans (areas of focus) for BHCs that are designed to help ensure that the funding and liquidity practices of the parent company and its nonbank subsidiaries do not have an adverse impact on the organization's depository institution subsidiaries, see SR-08-8 and section 1050.1.3.3.2 for large complex banking organizations. For the similar supervisory plans for regional banking organizations, see SR-08-9 and

section 1050.2.3.3.2. Both manual sections are titled "Parent Company and Nonbank Funding and Liquidity."

4066.0.1 APPENDIX A—INTERAGENCY POLICY STATEMENT ON FUNDING AND LIQUIDITY RISK MANAGEMENT

The Board of Governors of the Federal Reserve System (FRB)[1] issued this guidance to provide consistent interagency expectations on sound practices for managing funding and liquidity risk. The guidance summarizes the principles of sound liquidity risk management that the agencies have issued in the past[2] and, where appropriate, harmonizes these principles with the international statement recently issued by the Basel Committee on Banking Supervision titled "Principles for Sound Liquidity Risk Management and Supervision."[3]

Recent events illustrate that liquidity risk management at many financial institutions is in need of improvement. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans.

The following guidance reiterates the process that institutions should follow to appropriately identify, measure, monitor, and control their funding and liquidity risk. In particular, the guidance re-emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal well-developed contingency funding plan (CFP) as primary tools for measuring and managing liquidity risk. The agencies expect every depository financial institutions[4] to manage liquidity risk using processes and systems that are commensurate with the institution's complexity, risk profile, and scope of operations. Liquidity risk management processes and plans should be well documented and available for supervisory review. Failure to maintain an adequate liquidity risk management process will be considered an unsafe and unsound practice.

Liquidity and Liquidity Risk

Liquidity is a financial institution's capacity to meet its cash and collateral obligations at a reasonable cost. Maintaining an adequate level of liquidity depends on the institution's ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the institution.

Liquidity risk is the risk that an institution's financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet its obligations. An institution's obligations, and the funding sources used to meet them, depend significantly on its business mix, balance-sheet structure, and the cash flow profiles of its on- and off-balance-sheet obligations. In managing their cash flows, institutions confront various situations that can give rise to increased liquidity risk. These include funding mismatches, market constraints on the ability to convert assets into cash or in accessing sources of funds (i.e., market liquidity), and contingent liquidity events. Changes in economic conditions or exposure to credit, market, operation, legal, and reputation risks also can affect an institution's liquidity risk profile and should be considered in the assessment of liquidity and asset/liability management.

1. The policy statement in section 4066.0.1 is slightly amended to address those institutions supervised by the Federal Reserve. The interagency policy statement was also issued by the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA) (collectively, the agencies)—and the depository institutions those agencies supervise—in conjunction with the Conference of State Bank Supervisors (CSBS). For the complete text of the interagency policy statement see 75 *Fed. Reg.*13656. The various state banking supervisors may implement this policy statement through their individual supervisory process.

2. For national banks, see the *Comptroller's Handbook on Liquidity*. For state member banks and bank holding companies, see the Federal Reserve's *Commercial Bank Examination Manual* (section 4020), *Bank Holding Company Supervision Manual* (section 4010), and *Trading and Capital Markets Activities Manual* (section 2030). For state non-member banks, see the FDIC's *Revised Examination Guidance for Liquidity and Funds Management* (Trans. No. 2002-01) (Nov. 19, 2001) as well as Financial Institution Letter 84-2008, *Liquidity Risk Management* (August 2008). Also see Basel Committee on Banking Supervision, "Principles for Sound Liquidity Risk Management and Supervision," (September 2008).

3. Basel Committee on Banking Supervision, "Principles for Sound Liquidity Risk Management and Supervision," September 2008. See www.bis.org/publ/bcbs144.htm.

4. Unless otherwise indicated, this interagency guidance uses the term "depository financial institutions" or "institutions" to include banks and saving associations.

Sound Practices of Liquidity Risk Management

An institution's liquidity management process should be sufficient to meet its daily funding needs and cover both expected and unexpected deviations from normal operations. Accordingly, institutions should have a comprehensive management process for identifying, measuring, monitoring, and controlling liquidity risk. Because of the critical importance to the viability of the institution, liquidity risk management should be fully integrated into the institution's risk management processes. Critical elements of sound liquidity risk management include:

1. Effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution's control of liquidity risk.
2. Appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk.
3. Comprehensive liquidity risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution.
4. Active management of intraday liquidity and collateral.
5. An appropriately diverse mix of existing and potential future funding sources.
6. Adequate levels of highly liquid marketable securities, which are free of legal, regulatory, or operational impediments, that can be used to meet liquidity needs in stressful situations.
7. Comprehensive contingency funding plans (CFPs) that sufficiently address potential adverse liquidity events and emergency cash flow requirements.
8. Internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity risk management process.

Supervisors will assess these critical elements in their reviews of an institution's liquidity risk management process in relation to its size, complexity, and scope of operations.

Corporate Governance

The board of directors is ultimately responsible for the liquidity risk assumed by the institution. As a result, the board should ensure that the institution's liquidity risk tolerance is established and communicated in such a manner that all levels of management clearly understand the institution's approach to managing the trade-offs between liquidity risk and short-term profits. The board of directors or its delegated committee of board members should oversee the establishment and approval of liquidity management strategies, policies and procedures, and review them at least annually. In addition, the board should ensure that it:

- Understands the nature of the liquidity risks of its institution and periodically reviews information necessary to maintain this understanding.
- Establishes executive-level lines of authority and responsibility for managing the institution's liquidity risk.
- Enforces management's duties to identify, measure, monitor, and control liquidity risk.
- Understands and periodically reviews the institution's CFPs for handling potential adverse liquidity events.
- Understands the liquidity risk profiles of important subsidiaries and affiliates as appropriate.

Senior management is responsible for ensuring that board-approved strategies, policies, and procedures for managing liquidity (on both a long-term and day-to-day basis) are appropriately executed within the lines of authority and responsibility designated for managing and controlling liquidity risk. This includes overseeing the development and implementation of appropriate risk measurement and reporting systems, liquid buffers (e.g., cash, unencumbered marketable securities, and market instruments), CFPs, and an adequate internal control infrastructure. Senior management is also responsible for regularly reporting to the board of directors on the liquidity risk profile of the institution.

Senior management should determine the structure, responsibilities, and controls for managing liquidity risk and for overseeing the liquidity positions of the institution. These elements should be clearly documented in liquidity risk policies and procedures. For institutions comprised of multiple entities, such elements should be fully specified and documented in policies for each material legal entity and subsidiary. Senior management should be able to monitor liquidity risks for each entity across the institution on an ongoing basis. Processes should be in place to ensure that the group's senior management is actively monitoring and quickly responding to

all material developments and reporting to the boards of directors as appropriate.

Institutions should clearly identify the individuals or committees responsible for implementing and making liquidity risk decisions. When an institution uses an asset/liability committee (ALCO) or other similar senior management committee, the committee should actively monitor the institution's liquidity profile and should have sufficiently broad representation across major institutional functions that can directly or indirectly influence the institution's liquidity risk profile (e.g., lending, investment securities, and wholesale and retail funding). Committee members should include senior managers with authority over the units responsible for executing liquidity-related transactions and other activities within the liquidity risk management process. In addition, the committee should ensure that the risk measurement system adequately identifies and quantifies risk exposure. The committee also should ensure that the reporting process communicates accurate, timely, and relevant information about the level and sources of risk exposure.

Strategies, Policies, Procedures, and Risk Tolerances

Institutions should have documented strategies for managing liquidity risk and clear policies and procedures for limiting and controlling risk exposures that appropriately reflect the institution's risk tolerances. Strategies should identify primary sources of funding for meeting daily operating cash outflows, as well as seasonal and cyclical cash flow fluctuations. Strategies should also address alternative responses to various adverse business scenarios.[5] Policies and procedures should provide for the formulation of plans and courses of actions for dealing with potential temporary, intermediate-term, and long-term liquidity disruptions. Policies, procedures, and limits also should address liquidity separately for individual currencies, legal entities, and business lines, when appropriate and material, and should allow for legal, regulatory, and operational limits for the transferability of liquidity as well. Senior management should coordinate the institution's liquidity risk management with disaster, contingency, and strategic planning efforts, as well as with business line and risk management objectives, strategies, and tactics.

Policies should clearly articulate a liquidity risk tolerance that is appropriate for the business strategy of the institution, considering its complexity, business mix, liquidity risk profile, and its role in the financial system. Policies should also contain provisions for documenting and periodically reviewing assumptions used in liquidity projections. Policy guidelines should employ both quantitative targets and qualitative guidelines. For example, these measurements, limits, and guidelines may be specified in terms of the following measures and conditions, as applicable:

1. Cash flow projections that include discrete and cumulative cash flow mismatches or gaps over specified future time horizons under both expected and adverse business conditions.
2. Target amounts of unencumbered liquid asset reserves.
3. Measures used to identify unstable liabilities and liquid asset coverage ratios. For example, these may include ratios of wholesale funding to total liabilities, potentially volatile retail (e.g., high-cost or out-of-market) deposits to total deposits, and other liability dependency measures, such as short-term borrowings as a percent of total funding.
4. Asset concentrations that could increase liquidity risk through a limited ability to convert to cash (e.g., complex financial instruments,[6] bank-owned (corporate-owned) life insurance, and less marketable loan portfolios).
5. Funding concentrations that address diversification of funding sources and types, such as large liability and borrowed funds dependency, secured versus unsecured funding sources, exposures to single providers of funds, exposures to funds providers by market segments, and different types of brokered deposits or wholesale funding.
6. Funding concentrations that address the term, re-pricing, and market characteristics of funding sources with consideration given to the nature of the assets they fund. This may include diversification targets for short-, medium-, and long-term funding; instrument type and securitization vehicles; and guid-

5. In formulating liquidity management strategies, members of complex banking groups should take into consideration their legal structures (e.g., branches versus separate legal entities and operating subsidiaries), key business lines, markets, products, and jurisdictions in which they operate.

6. Financial instruments that are illiquid, difficult to value, or marked by the presence of cash flows that are irregular, uncertain, or difficult to model.

ance on concentrations for currencies and geographical markets.

7. Contingent liability exposures such as unfunded loan commitments, lines of credit supporting asset sales or securitizations, and collateral requirements for derivatives transactions and various types of secured lending.
8. Exposures of material activities, such as securitization, derivatives, trading, transaction processing, and international activities, to broad systemic and adverse financial market events. This is most applicable to institutions with complex and sophisticated liquidity risk profiles.
9. Alternative measures and conditions that may be appropriate for certain institutions.

Policies also should specify the nature and frequency of management reporting. In normal business environments, senior managers should receive liquidity risk reports at least monthly, while the board of directors should receive liquidity risk reports at least quarterly. Depending upon the complexity of the institution's business mix and liquidity risk profile, management reporting may need to be more frequent. Regardless of an institution's complexity, it should have the ability to increase the frequency of reporting on short notice, if the need arises. Liquidity risk reports should impart to senior management and the board a clear understanding of the institution's liquidity risk exposure, compliance with risk limits, consistency between management's strategies and tactics, and consistency between these strategies and the board's expressed risk tolerance.

Institutions should consider liquidity costs, benefits, and risks in strategic planning and budgeting processes. Significant business activities should be evaluated for both liquidity risk exposure and profitability. More complex and sophisticated institutions should incorporate liquidity costs, benefits, and risks in the internal product pricing, performance measurement, and new product approval process for all material business lines, products, and activities. Incorporating the cost of liquidity into these functions should align the risk-taking incentives of individual business lines with the liquidity risk exposure their activities create for the institution as a whole. The quantification and attribution of liquidity risks should be explicit and transparent at the line management level and should include consideration of how liquidity would be affected under stressed conditions.

Liquidity Risk Measurement, Monitoring, and Reporting

The process of measuring liquidity risk should include robust methods for comprehensively projecting cash flows arising from assets, liabilities, and off-balance-sheet items over an appropriate set of time horizons. For example, time buckets may be daily for very short timeframes or extend out to weekly, monthly, and quarterly for longer time frames. Pro forma cash flow statements are a critical tool for adequately managing liquidity risk. Cash flow projections can range from simple spreadsheets to very detailed reports depending upon the complexity and sophistication of the institution and its liquidity risk profile under alternative scenarios. Given the critical importance that assumptions play in constructing measures of liquidity risk and projections of cash flows, institutions should ensure that the assumptions used are reasonable, appropriate, and adequately documented. Institutions should periodically review and formally approve these assumptions. Institutions should focus particular attention on the assumptions used in assessing the liquidity risk of complex assets, liabilities, and off-balance-sheet positions. Assumptions applied to positions with uncertain cash flows, including the stability of retail and brokered deposits and secondary market issuances and borrowings, are especially important when they are used to evaluate the availability of alternative sources of funds under adverse contingent liquidity scenarios. Such scenarios include, but are not limited to, deterioration in the institution's asset quality or capital adequacy.

Institutions should ensure that assets are properly valued according to relevant financial reporting and supervisory standards. An institution should fully factor into its risk management practices the consideration that valuations may deteriorate under market stress and take this into account in assessing the feasibility and impact of asset sales on its liquidity position during stress events.

Institutions should ensure that their vulnerabilities to changing liquidity needs and liquidity capacities are appropriately assessed within meaningful time horizons, including intraday, day-to-day, short-term weekly and monthly horizons, medium-term horizons of up to one year, and longer-term liquidity needs of one year or more. These assessments should include vulnerabilities to events, activities, and strate-

gies that can significantly strain the capability to generate internal cash.

Stress Testing

Institutions should conduct stress tests regularly for a variety of institution-specific and marketwide events across multiple time horizons. The magnitude and frequency of stress testing should be commensurate with the complexity of the financial institution and the level of its risk exposures. Stress test outcomes should be used to identify and quantify sources of potential liquidity strain and to analyze possible impacts on the institution's cash flows, liquidity position, profitability, and solvency. Stress tests should also be used to ensure that current exposures are consistent with the financial institution's established liquidity risk tolerance. Management's active involvement and support is critical to the effectiveness of the stress testing process. Management should discuss the results of stress tests and take remedial or mitigating actions to limit the institution's exposures, build up a liquidity cushion, and adjust its liquidity profile to fit its risk tolerance. The results of stress tests should also play a key role in shaping the institution's contingency planning. As such, stress testing and contingency planning are closely intertwined.

Collateral Position Management

An institution should have the ability to calculate all of its collateral positions in a timely manner, including the value of assets currently pledged relative to the amount of security required and unencumbered assets available to be pledged. An institution's level of available collateral should be monitored by legal entity, jurisdiction, and currency exposure, and systems should be capable of monitoring shifts between intraday and overnight or term collateral usage. An institution should be aware of the operational and timing requirements associated with accessing the collateral given its physical location (i.e., the custodian institution or securities settlement system with which the collateral is held). Institutions should also fully understand the potential demand on required and available collateral arising from various types of contractual contingencies during periods of both marketwide and institution-specific stress.

Management Reporting

Liquidity risk reports should provide aggregate information with sufficient supporting detail to enable management to assess the sensitivity of the institution to changes in market conditions, its own financial performance, and other important risk factors. The types of reports or information and their timing will vary according to the complexity of the institution's operations and risk profile. Reportable items may include but are not limited to cash flow gaps, cash flow projections, asset and funding concentrations, critical assumptions used in cash flow projections, key early warning or risk indicators, funding availability, status of contingent funding sources, or collateral usage. Institutions should also report on the use of and availability of government support, such as lending and guarantee programs, and implications on liquidity positions, particularly since these programs are generally temporary or reserved as a source for contingent funding.

Liquidity across Currencies, Legal Entities, and Business Lines

A depository institution should actively monitor and control liquidity risk exposures and funding needs within and across currencies, legal entities, and business lines. Also, depository institutions should take into account operational limitations to the transferability of liquidity, and should maintain sufficient liquidity to ensure compliance during economically stressed periods with applicable legal and regulatory restrictions on the transfer of liquidity among regulated entities. The degree of centralization in managing liquidity should be appropriate for the depository institution's business mix and liquidity risk profile.[7] The agencies expect depository institutions to maintain adequate liquidity both at the consolidated level and at significant legal entities.

Regardless of its organizational structure, it is important that an institution actively monitor and control liquidity risks at the level of individual legal entities, and the group as a whole, incorporating processes that aggregate data across multiple systems in order to develop a group-wide view of liquidity risk exposures. It is also important that the institution identify constraints on the transfer of liquidity within the group.

7. Institutions subject to multiple regulatory jurisdictions should have management strategies and processes that recognize the potential limitations of liquidity transferability, as well as the need to meet the liquidity requirements of foreign jurisdictions.

Assumptions regarding the transferability of funds and collateral should be described in liquidity risk management plans.

Intraday Liquidity Position Management

Intraday liquidity monitoring is an important component of the liquidity risk management process for institutions engaged in significant payment, settlement, and clearing activities. An institution's failure to manage intraday liquidity effectively, under normal and stressed conditions, could leave it unable to meet payment and settlement obligations in a timely manner, adversely affecting its own liquidity position and that of its counterparties. Among large, complex organizations, the interdependencies that exist among payment systems and the inability to meet certain critical payments has the potential to lead to systemic disruptions that can prevent the smooth functioning of all payment systems and money markets. Therefore, institutions with material payment, settlement and clearing activities should actively manage their intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. Senior management should develop and adopt an intraday liquidity strategy that allows the institution to:

1. Monitor and measure expected daily gross liquidity inflows and outflows.
2. Manage and mobilize collateral when necessary to obtain intraday credit.
3. Identify and prioritize time-specific and other critical obligations in order to meet them when expected.
4. Settle other less critical obligations as soon as possible.
5. Control credit to customers when necessary.
6. Ensure that liquidity planners understand the amounts of collateral and liquidity needed to perform payment-system obligations when assessing the organization's overall liquidity needs.

Diversified Funding

An institution should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. An institution should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.

An institution should diversify available funding sources in the short-, medium-, and long-term. Diversification targets should be part of the medium- to long-term funding plans and should be aligned with the budgeting and business planning process. Funding plans should take into account correlations between sources of funds and market conditions. Funding should also be diversified across a full range of retail as well as secured and unsecured wholesale sources of funds, consistent with the institution's sophistication and complexity. Management should also consider the funding implications of any government programs or guarantees it uses. As with wholesale funding, the potential unavailability of government programs over the intermediate- and long-term should be fully considered in the development of liquidity risk management strategies, tactics, and risk tolerances. Funding diversification should be implemented using limits addressing counterparties, secured versus unsecured market funding, instrument type, securitization vehicle, and geographic market. In general, funding concentrations should be avoided. Undue over-reliance on any one source of funding is considered an unsafe and unsound practice.

An essential component of ensuring funding diversity is maintaining market access. Market access is critical for effective liquidity risk management as it affects both the ability to raise new funds and to liquidate assets. Senior management should ensure that market access is being actively managed, monitored, and tested by the appropriate staff. Such efforts should be consistent with the institution's liquidity risk profile and sources of funding. For example, access to the capital markets is an important consideration for most large complex institutions, whereas the availability of correspondent lines of credit and other sources of wholesale funds are critical for smaller, less complex institutions.

An institution should identify alternative sources of funding that strengthen its capacity to withstand a variety of severe institution-specific and marketwide liquidity shocks. Depending upon the nature, severity, and duration of the liquidity shock, potential sources of funding include, but are not limited to, the following:

1. Deposit growth.
2. Lengthening maturities of liabilities.
3. Issuance of debt instruments.
4. Sale of subsidiaries or lines of business.
5. Asset securitization.
6. Sale (either outright or through repurchase agreements) or pledging of liquid assets.
7. Drawing down committed facilities.
8. Borrowing.

Cushion of Liquid Assets

Liquid assets are an important source of both primary (operating liquidity) and secondary (contingent liquidity) funding at many institutions. Indeed, a critical component of an institution's ability to effectively respond to potential liquidity stress is the availability of a cushion of highly liquid assets without legal, regulatory, or operational impediments (i.e., unencumbered) that can be sold or pledged to obtain funds in a range of stress scenarios. These assets should be held as insurance against a range of liquidity stress scenarios including those that involve the loss or impairment of typically available unsecured and/or secured funding sources. The size of the cushion of such high-quality liquid assets should be supported by estimates of liquidity needs performed under an institution's stress testing as well as aligned with the risk tolerance and risk profile of the institution. Management estimates of liquidity needs during periods of stress should incorporate both contractual and noncontractual cash flows, including the possibility of funds being withdrawn. Such estimates should also assume the inability to obtain unsecured and uninsured funding as well as the loss or impairment of access to funds secured by assets other than the safest, most liquid assets.

Management should ensure that unencumbered, highly liquid assets are readily available and are not pledged to payment systems or clearing houses. The quality of unencumbered liquid assets is important as it will ensure accessibility during the time of most need. An institution could use its holdings of high-quality securities, for example, U.S. Treasury securities, securities issued by U.S. government-sponsored agencies, excess reserves at the central bank or similar instruments, and enter into repurchase agreements in response to the most severe stress scenarios.

Contingency Funding Plan[8]

All financial institutions, regardless of size and complexity, should have a formal CFP that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. It should be regularly tested and updated to ensure that it is operationally sound. For certain components of the CFP, affirmative testing (e.g., liquidation of assets) may be impractical. In these instances, institutions should be sure to test operational components of the CFP. For example, ensuring that roles and responsibilities are up-to-date and appropriate; ensuring that legal and operational documents are up-to-date and appropriate; ensuring that cash and collateral can be moved where and when needed; and ensuring that contingent liquidity lines can be drawn when needed.

Contingent liquidity events are unexpected situations or business conditions that may increase liquidity risk. The events may be institution-specific or arise from external factors and may include:

1. The institution's inability to fund asset growth.
2. The institution's inability to renew or replace maturing funding liabilities.
3. Customers unexpectedly exercising options to withdraw deposits or exercise off-balance-sheet commitments.
4. Changes in market value and price volatility of various asset types.
5. Changes in economic conditions, market perception, or dislocations in the financial markets.
6. Disturbances in payment and settlement systems due to operational or local disasters.

Insured institutions should be prepared for the specific contingencies that will be applicable to them if they become less than Well Capitalized pursuant to Prompt Correction Action (PCA) provisions under the Federal Deposit Insurance Corporation Improvement Act.[9] Contingencies may include restricted rates paid for deposits, the need to seek approval from the FDIC/NCUA to accept brokered deposits, and the inability to

8. Financial institutions that have had their liquidity supported by temporary government programs administered by the Department of the Treasury, Federal Reserve, and/or FDIC should not base their liquidity strategies on the belief that such programs will remain in place indefinitely.

9. See 12 USC 1831o, 12 CFR 6 (OCC), 12 CFR 208.40 (FRB), and 12 CFR 325.101 (FDIC).

accept any brokered deposits.[10]

A CFP provides a documented framework for managing unexpected liquidity situations. The objective of the CFP is to ensure that the institution's sources of liquidity are sufficient to fund normal operating requirements under contingent events. A CFP also identifies alternative contingent liquidity resources[11] that can be employed under adverse liquidity circumstances. An institution's CFP should be commensurate with its complexity, risk profile, and scope of operations. As macroeconomic and institution-specific conditions change, CFPs should be revised to reflect these changes.

Contingent liquidity events can range from high-probability/low-impact events to low-probability/high-impact events. Institutions should incorporate planning for high-probability/low-impact liquidity risks into the day-to-day management of sources and uses of funds. Institutions can generally accomplish this by assessing possible variations around expected cash flow projections and providing for adequate liquidity reserves and other means of raising funds in the normal course of business. In contrast, all financial institution CFPs will typically focus on events that, while relatively infrequent, could significantly impact the institution's operations. A CFP should:

1. *Identify Stress Events*. Stress events are those that may have a significant impact on the institution's liquidity given its specific balance-sheet structure, business lines, organizational structure, and other characteristics. Possible stress events may include deterioration in asset quality, changes in agency credit ratings, PCA capital categories and CAMELS ratings downgrades, widening of credit default spreads, operating losses, declining financial institution equity prices, negative press coverage, or other events that may call into question an institution's ability to meet its obligations.
2. *Assess Levels of Severity and Timing.* The CFP should delineate the various levels of stress severity that can occur during a contingent liquidity event and identify the different stages for each type of event. The events, stages, and severity levels identified should include temporary disruptions as well as those that might be more intermediate term or longer-term. Institutions can use the different stages or levels of severity identified to design early-warning indicators, assess potential funding needs at various points in a developing crisis, and specify comprehensive action plans. The length of the scenario will be determined by the type of stress event being modeled and should encompass the duration of the event.
3. *Assess Funding Sources and Needs.* A critical element of the CFP is the quantitative projection and evaluation of expected funding needs and funding capacity during the stress event. This entails an analysis of the potential erosion in funding at alternative stages or severity levels of the stress event and the potential cash flow mismatches that may occur during the various stress levels. Management should base such analysis on realistic assessments of the behavior of funds providers during the event and incorporate alternative contingency funding sources. The analysis also should include all material on-and off-balance-sheet cash flows and their related effects. The result should be a realistic analysis of cash inflows, outflows, and funds availability at different time intervals during the potential liquidity stress event in order to measure the institution's ability to fund operations. Common tools to assess funding mismatches include:
   a. *Liquidity gap analysis*—A cash flow report that essentially represents a base case estimate of where funding surpluses and shortfalls will occur over various future time frames.
   b. *Stress tests*—A pro forma cash flow report with the ability to estimate future funding surpluses and shortfalls under various liquidity stress scenarios and the institution's ability to fund expected asset growth projections or sustain an orderly liquidation of assets under various stress events.
4. *Identify Potential Funding Sources.* Because liquidity pressures may spread from one funding source to another during a significant liquidity event, institutions should identify alternative sources of liquidity, and ensure ready access to contingent funding sources. In some cases, these funding sources may rarely be used in the normal course of busi-

10. Section 38 of the FDI Act (12 USC 1831o) requires insured depository institutions that are not well capitalized to receive approval prior to engaging in certain activities. Section 38 restricts or prohibits certain activities and requires an insured depository institution to submit a capital restoration plan when it becomes undercapitalized.

11. There may be time constraints, sometimes lasting weeks, encountered in initially establishing lines with FRB and/or FHLB. As a result, financial institutions should plan to have these lines set up well in advance.

ness. Therefore, institutions should conduct advance planning and periodic testing to ensure that contingent funding sources are readily available when needed.

5. *Establish Liquidity Event Management Processes.* The CFP should provide for a reliable crisis management team and administrative structure, including realistic action plans used to execute the various elements of the plan for given levels of stress. Frequent communication and reporting among team members, the board of directors, and other affected managers optimize the effectiveness of a contingency plan during an adverse liquidity event by ensuring that business decisions are coordinated to minimize further disruptions to liquidity. Such events may also require the daily computation of regular liquidity risk reports and supplemental information. The CFP should provide for more frequent and more detailed reporting as the stress situation intensifies.
6. *Establish a Monitoring Framework for Contingent Events.* Institution management should monitor for potential liquidity stress events by using early-warning indicators and event triggers. The institution should tailor these indicators to its specific liquidity risk profile. The early recognition of potential events allows the institution to position itself into progressive states of readiness as the event evolves, while providing a framework to report or communicate within the institution and to outside parties. Early-warning signals may include, but are not limited to, negative publicity concerning an asset class owned by the institution, increased potential for deterioration in the institution's financial condition, widening debt or credit default swap spreads, and increased concerns over the funding of off-balance-sheet items.

To mitigate the potential for reputation contagion, effective communication with counterparties, credit-rating agencies, and other stakeholders when liquidity problems arise is of vital importance. Smaller institutions that rarely interact with the media should have plans in place for how they will manage press inquiries that may arise during a liquidity event. In addition, groupwide contingency funding plans, liquidity cushions, and multiple sources of funding are mechanisms that may mitigate reputation concerns.

In addition to early-warning indicators, institutions that issue public debt, use warehouse financing, securitize assets, or engage in material over-the-counter derivative transactions typically have exposure to event triggers embedded in the legal documentation governing these transactions. Institutions that rely upon brokered deposits should also incorporate PCA-related downgrade triggers into their CFPs since a change in PCA status could have a material bearing on the availability of this funding source. Contingent event triggers should be an integral part of the liquidity risk monitoring system. Institutions that originate and/or purchase loans for asset securitization programs pose heightened liquidity risk concerns due to the unexpected funding needs associated with an early amortization event or disruption of warehouse funding. Institutions that securitize assets should have liquidity contingency plans that address these risks.

Institutions that rely upon secured funding sources also are subject to potentially higher margin or collateral requirements that may be triggered upon the deterioration of a specific portfolio of exposures or the overall financial condition of the institution. The ability of a financially stressed institution to meet calls for additional collateral should be considered in the CFP. Potential collateral values also should be subject to stress tests since devaluations or market uncertainty could reduce the amount of contingent funding that can be obtained from pledging a given asset. Additionally, triggering events should be understood and monitored by liquidity managers.

Institutions should test various elements of the CFP to assess their reliability under times of stress. Institutions that rarely use the type of funds they identify as standby sources of liquidity in a stress situation, such as the sale or securitization of loans, securities repurchase agreements, Federal Reserve discount window borrowing, or other sources of funds, should periodically test the operational elements of these sources to ensure that they work as anticipated. However, institutions should be aware that during real stress events, prior market access testing does not guarantee that these funding sources will remain available within the same time frames and/or on the same terms.

Larger, more complex institutions can benefit by employing operational simulations to test communications, coordination, and decision making involving managers with different responsibilities, in different geographic locations, or at different operating subsidiaries. Simulations or tests run late in the day can highlight specific

problems, such as difficulty in selling assets or borrowing new funds at a time when business in the capital markets may be less active.

Internal Controls

An institution's internal controls consist of procedures, approval processes, reconciliations, reviews, and other mechanisms designed to provide assurance that the institution manages liquidity risk consistent with board-approved policy. Appropriate internal controls should address relevant elements of the risk management process, including adherence to policies and procedures, the adequacy of risk identification, risk measurement, reporting, and compliance with applicable rules and regulations.

Management should ensure that an independent party regularly reviews and evaluates the various components of the institution's liquidity risk management process. These reviews should assess the extent to which the institution's liquidity risk management complies with both supervisory guidance and industry sound practices, taking into account the level of sophistication and complexity of the institution's liquidity risk profile.[12] Smaller, less-complex institutions may achieve independence by assigning this responsibility to the audit function or other qualified individuals independent of the risk management process. The independent review process should report key issues requiring attention, including instances of noncompliance, to the appropriate level of management for prompt corrective action consistent with approved policy.

4066.0.2 APPENDIX B—INTERAGENCY GUIDANCE ON FUNDS TRANSFER PRICING RELATED TO FUNDING AND CONTINGENT LIQUIDITY RISKS

The Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) issued this guidance on funds transfer pricing (FTP) practices related to funding risk (including interest rate and liquidity components) and contingent liquidity risk at large financial institutions (hereafter referred to as "firms") to address weaknesses observed in some firms' FTP practices.[13] The guidance builds on the principles of sound liquidity risk management described in the "Interagency Policy Statement on Funding and Liquidity Risk Management,"[14] and incorporates elements of the international statement issued by the Basel Committee on Banking Supervision titled "Principles for Sound Liquidity Risk Management and Supervision."[15] Refer to SR-16-03.

Background

For purposes of this guidance, FTP refers to a process performed by a firm's central management function that allocates costs and benefits associated with funding and contingent liquidity risks (FTP costs and benefits), as measured at transaction or trade inception, to a firm's business lines, products, and activities. While this guidance specifically addresses FTP practices related to funding and contingent liquidity risks, firms may incorporate other risks in their overall FTP frameworks.

FTP is an important tool for managing a firm's balance sheet structure and measuring risk-adjusted profitability. By allocating funding and contingent liquidity risks to business lines, products, and activities within a firm, FTP influences the volume and terms of new business and ongoing portfolio composition. This process helps align a firm's funding and contingent liquidity risk profile and risk appetite and complements, but does not replace, broader liquidity and interest rate risk management programs (for example, stress testing) that a firm uses to capture certain risks (for example, basis risk). If

12. This includes the standards established in this interagency guidance as well as the supporting material each agency provides in its examination manuals and handbooks directed at their supervised institutions. Industry standards include those advanced by recognized industry associations and groups.

13. For purposes of this guidance, large financial institutions include: national banks, federal savings associations and state-chartered banks with consolidated assets of $250 billion or more, domestic bank and savings and loan holding companies with consolidated assets of $250 billion or more or foreign exposure of $10 billion or more, and foreign banking organizations with combined U.S. assets of $250 billion or more.

14. Refer to: FRB's SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management"; FDIC's FIL-13-2010, "Funding and Liquidity Risk Management Interagency Guidance"; and OCC Bulletin 2010-13, "Final Policy Statement: Interagency Policy Statement on Funding and Liquidity Management."

15. The Basel Committee on Banking Supervision statement on "Principles for Sound Liquidity Risk Management and Supervision" (September 2008) is available at www.bis.org/publ/bcbs144.htm.

done effectively, FTP promotes more resilient, sustainable business models. FTP is also an important tool for centralizing the management of funding and contingent liquidity risks for all exposures. Through FTP, a firm can transfer these risks to a central management function that can take advantage of natural offsets, centralized hedging activities, and a broader view of the firm.

Failure to consistently and effectively apply FTP can misalign the risk-taking incentives of individual business lines with the firm's risk appetite, resulting in a misallocation of financial resources. This misallocation can arise in new business and ongoing portfolio composition where the business metrics do not reflect risks taken, thereby undermining the business model. Examples include entering into excessive off-balance sheet commitments and on-balance sheet asset growth because of mispriced funding and contingent liquidity risks.

The 2008 financial crisis exposed weak risk management practices for allocating liquidity costs and benefits across business lines. Several firms "acknowledged that if robust FTP practices had been in place earlier, and if the systems had charged not just for funding but for liquidity risks, they would not have carried the significant levels of illiquid assets and the significant risks that were held off-balance sheet that ultimately led to sizable losses."[16]

Funds Transfer Pricing Principles

A firm should have an FTP framework to support its broader risk management and governance processes that incorporates the general principles described in this section and is commensurate with its size, complexity, business activities, and overall risk profile. The framework should incorporate FTP costs and benefits into product pricing, business metrics, and new product approval for all material business lines, products, and activities to align risk-taking incentives with the firm's risk appetite.

Principle 1: A firm should allocate FTP costs and benefits based on funding risk and contingent liquidity risk.

A firm should have an FTP framework that allocates costs and benefits based on the following risks.

- *Funding risk,* measured as the cost or benefit (including liquidity and interest rate components) of raising funds to finance ongoing business operations, should be allocated based on the characteristics of the business lines, products, and activities that give rise to those costs or benefits (for example, higher costs allocated to assets that will be held over a longer time horizon and greater benefits allocated to stable sources of funding).
- *Contingent liquidity risk,* measured as the cost of holding standby liquidity composed of unencumbered, highly liquid assets, should be allocated to the business lines, products, and activities that pose risk of contingent funding needs during a stress event (for example, draws on credit commitments, collateral calls, deposit run-off, and increasing haircuts on secured funding).

Principle 2: A firm should have a consistent and transparent FTP framework for identifying and allocating FTP costs and benefits on a timely basis and at a sufficiently granular level, commensurate with the firm's size, complexity, business activities, and overall risk profile.

FTP costs and benefits should be allocated based on methodologies that are set forth by a firm's FTP framework. The methodologies should be transparent, repeatable, and sufficiently granular such that they align business decisions with the firm's desired funding and contingent liquidity risk appetite. To the extent a firm applies FTP at an aggregated level to similar products and activities, the firm should include the aggregating criteria in the report on FTP.[17] Additionally, the senior management group that oversees FTP should review the basis for the FTP methodologies. The attachment to this interagency guidance describes illustrative FTP methodologies that a firm may consider when implementing its FTP framework.[18]

A firm should allocate FTP costs and benefits, as measured at transaction or trade inception, to the appropriate business line, product, or activity. If a firm retains any FTP costs or benefits in a centrally managed pool pursuant to its FTP framework, it should analyze the implications of

16. Senior Supervisors Group report on "Risk Management Lessons from the Global Financial Crisis of 2008" (October 21, 2009) is available at https://www.newyorkfed.org/medialibrary/media/newsevents/news/banking/2009/SSG_report.pdf.

17. See Principle 3 for a discussion of the report on FTP.

18. The FRB, the FDIC, and the OCC will monitor evolving FTP practices in the market and may update or add to the illustrative methodologies in the interagency guidance attachment.

such decisions on business line incentives and the firm's overall risk profile. The firm customarily would include its findings in the report on FTP.

The FTP framework should be implemented consistently across the firm to appropriately align risk-taking incentives. While it is possible to apply different FTP methodologies within a firm due to, among other things, legal entity type or specific jurisdictional circumstances, a firm should generally implement the FTP framework in a consistent manner across its corporate structure to reduce the likelihood of misaligned incentives. If there are implementation differences across the firm, management should analyze the implications of such differences on business line incentives and the firm's overall funding and contingent liquidity risk profile. The firm customarily would include its findings in the report on FTP.

A firm should allocate, report, and update data on FTP costs and benefits at a frequency that is appropriate for the business line, product, or activity. Allocating, reporting, and updating of data should occur more frequently for trading exposures (for example, on a daily basis). Infrequent allocation, reporting, or updating of data for trading exposures (for example, based on month-end positions) may not fully capture a firm's day-to-day funding and contingent liquidity risks. For example, a firm should monitor the age of its trading exposures, and those held longer than originally intended should be reassessed and FTP costs and benefits should be reallocated based on the modified holding period.

A firm's FTP framework should address derivative activities commensurate with the size and complexity of those activities. The FTP framework may consider the fair value of current positions, the rights of rehypothecation for collateral received, and contingent outflows that may occur during a stress event.

To avoid a misalignment of risk-taking incentives, a firm should adjust its FTP costs and benefits as appropriate based on both market-wide and idiosyncratic conditions, such as trapped liquidity, reserve requirements, regulatory requirements, illiquid currencies, and settlement or clearing costs. These idiosyncratic conditions should be contemplated in the FTP framework, and the firm customarily would include a discussion of the implications in the report on FTP.

Principle 3: A firm should have a robust governance structure for FTP, including the production of a report on FTP and oversight from a senior management group and central management function.

A firm should have a senior management group that oversees FTP, which should include a broad range of stakeholders, such as representatives from the firm's asset-liability committee (if separate from the senior management group), the treasury function, and business line and risk management functions. This group should develop the policy underlying the FTP framework, which should identify assumptions, responsibilities, procedures, and authorities for FTP. The policy should be reviewed and updated on a regular basis or when the firm's asset-liability structure or scope of activities undergoes a material change. Further, senior management with oversight responsibility for FTP should periodically, but no less frequently than quarterly, review the report on FTP to ensure that the established FTP framework is being properly implemented.

A firm should also establish a central management function tasked with implementing the FTP framework. The central management function should have visibility over the entire firm's on- and off-balance sheet exposures. Among its responsibilities, the central management function should regularly produce and analyze a report on FTP generated from accurate and reliable management information systems. The report on FTP should be at a sufficiently granular level to enable the senior management group and central management function to effectively monitor the FTP framework (for example, at the business line, product, or activity level, as appropriate). Among other items, all material approvals, such as those related to any exception to the FTP framework, including the reason for the exception, would customarily be documented in the report on FTP. The report on FTP may be standalone or included within a broader risk management report.

Independent risk and control functions and internal audit should provide oversight of the FTP process and assess the report on FTP, which should be reviewed as appropriate to reflect changing business and financial market conditions and to maintain the appropriate alignment of incentives. Lastly, consistent with existing supervisory guidance on model risk management,[19] models used in FTP implementation should be independently validated and regularly reviewed to ensure that the models continue to

19. Refer to: FRB's SR-11-7, "Guidance on Model Risk Management"; OCC Bulletin 2011-12, "Supervisory Guidance on Model Risk Management." Refer to section 2126.0 of this manual.

perform as expected, that all assumptions remain appropriate, and that limitations are understood and appropriately mitigated.

Principle 4: A firm should align business incentives with risk management and strategic objectives by incorporating FTP costs and benefits into product pricing, business metrics, and new product approval.

Through its FTP framework, a firm should incorporate FTP costs and benefits into product pricing, business metrics, and new product approval for all material business lines, products, and activities (both on- and off-balance sheet). The framework, the report on FTP, and any associated management information systems should be designed to provide decision makers sufficient and timely information about FTP costs and benefits so that risk-taking incentives align with the firm's strategic objectives.

The information may be either at the transaction level or, if the transactions have homogenous funding and contingent liquidity risk characteristics, at an aggregated level. In deciding whether to allocate FTP costs and benefits at the transaction or aggregated level, firms should consider advantages and disadvantages of both approaches when developing the FTP framework. Although transaction-level FTP allocations may add complexity and involve higher implementation and maintenance costs, such allocations may provide a more accurate measure of risk-adjusted profitability. A firm assigning FTP allocations at an aggregated level should have aggregation criteria based on funding and contingent liquidity risk characteristics that are transparent.

There should be ongoing dialogue between the business lines and the central function responsible for allocating FTP costs and benefits to ensure that funding and contingent liquidity risks are being captured and are well-understood for product pricing, business metrics, and new product approval. The business lines should understand the rationale for the FTP costs and benefits, and the central function should understand the funding and contingent liquidity risks implicated by the business lines' transactions. Decisions by senior management to incentivize certain behaviors through FTP costs and benefits customarily would be documented and included in the report on FTP.

Conclusion

A firm should use the principles laid out in this guidance to develop, implement, and maintain an effective FTP framework. In doing so, a firm's risk-taking incentives should better align with its risk management and strategic objectives. The framework should be adequately tailored to a firm's size, complexity, business activities, and overall risk profile.

Interagency Guidance Attachment Illustrative Funds Transfer Pricing Methodologies

March 1, 2016

The Funds Transfer Pricing (FTP) methodologies described below are intended for illustrative purposes only and provide examples for addressing principles set forth in the guidance. A firm's FTP framework should be commensurate with its size, complexity, business activities, and overall risk profile. In designing its FTP framework, a firm may utilize other methodologies that are consistent with the principles set forth in the guidance. Therefore, these illustrative methodologies should not be interpreted as directives for implementing any particular FTP methodology.

Non-Trading Exposures

For non-trading exposures, a firm's FTP methodology may vary based on its business activities and specific exposures. For example, certain firms may have higher concentrations of exposures that have less predictable time horizons, such as non-maturity loans and non-maturity deposits.

Matched-Maturity Marginal Cost of Funding

Matched-maturity marginal cost of funding is a commonly used methodology for non-trading exposures. Under this methodology, FTP costs and benefits are based on a firm's market cost of funds across the term structure (for example, wholesale long-term debt curve adjusted based on the composition of the firm's alternate sources of funding such as Federal Home Loan Bank advances and customer deposits). This methodology incentivizes business lines to generate stable funding (for example, core deposits) by

crediting them the benefit or premium associated with such funding. It also ensures that business lines are appropriately charged the cost of funding for the life of longer-dated assets (for example, a five-year commercial loan). Given that funding costs can change over time, the market cost of funds across the term structure should be derived from reliable and readily available data sources and be well understood by FTP users.

FTP rates should, as closely as possible, match the characteristics of the transaction or the aggregated transactions to which they are applied. In determining the appropriate point on the derived FTP curve for a transaction or pool of transactions, a firm could consider a variety of characteristics, including the holding period, cash flow, re-pricing, prepayments, and expected life of the transaction or pool. For example, for a five-year commercial loan that has a rate that resets every three months and will be held to maturity, the interest rate component of the funding risk could be based on a three-month horizon for determining the FTP cost, and the liquidity component of the funding risk could be based on a five-year horizon for determining the FTP cost. Thus, the total FTP cost for holding the five-year commercial loan would be the combination of these two components.

Contingent Liquidity Risk

A firm may calculate the FTP cost related to non-trading exposure contingent liquidity risk using models based on behavioral assumptions. For example, charges for contingent commitments could be based on their modeled likelihood of drawdown, considering customer drawdown history, credit quality, and other factors; whereas, credits applied to deposits could be based on volatility and modeled behavioral maturity. A firm should document and include all modeling analyses and assumptions in the report on FTP. If behavioral assumptions used in a firm's FTP framework do not align with behavioral assumptions used in its internal stress test for similar types of non-trading exposures, the firm should document and include in the report on FTP these inconsistencies.

Trading Exposures

For trading exposures, a firm could consider a variety of factors, including the type of funding source (for example, secured or unsecured), the market liquidity of the exposure (for example, the size of the haircut relative to the overall exposure), the holding period of the position, the prevailing market conditions, and any potential impact the chosen approach could have on firm incentives and overall risk profile. If a firm's trading activities are not material, its FTP framework may require a less complex methodology for trading exposures. The following FTP methodologies have been observed for allocating FTP costs for trading exposures.

Weighted Average Cost of Debt (WACD)

WACD is the weighted average cost of outstanding firm debt, usually expressed as a spread over an index. Some firms' practices apply this rate to the amount of an asset expected to be funded unsecured (repurchase agreement market haircuts may be used to delineate between the amount being funded secured and the amount being funded unsecured). A firm using WACD should analyze whether the methodology misaligns risk-taking incentives and document such analyses in the report on FTP.

Marginal Cost of Funding

Marginal cost of funding sets the FTP costs at the appropriate incremental borrowing rate of a firm. Some firms' practices apply a marginal secured borrowing rate to the amount of an asset expected to be funded secured and a marginal unsecured borrowing rate to the amount of an asset expected to be funded unsecured (repurchase agreement market haircuts may be used to delineate between the amount being funded secured and the amount being funded unsecured). A firm using marginal cost of funding should analyze whether the methodology misaligns risk-taking incentives, considering current market rates compared to historical rates, and document such analyses in the report on FTP.

Contingent Liquidity Risk

A firm may calculate the FTP costs related to contingent liquidity risk from trading exposures by considering the unencumbered liquid assets that are held to cover the potential for widening haircuts of trading exposures that are funded secured. If haircuts used in a firm's FTP frame-

work do not align with haircuts used in its internal stress test for similar types of trading exposures, the firm should document and include in the report on FTP these inconsistencies. Haircuts should be updated at a frequency that is appropriate for a firm's trading activities and market conditions.

A firm may also include the FTP costs related to contingent liquidity risk from potential derivative outflows in stressed market conditions, which may be due to, for example, credit rating downgrades, additional termination rights, or market shocks and volatility.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2009, this section has been revised to recognize the supervisory guidance contained in SR-08-12 and its interagency attachment, "Changes to the Interagency Country Exposure Review Committee (ICERC) Process." A significant change was made to the ICERC rating process—ICERC will only rate countries that are in default.[1]

4090.0.05 DEFINITION, COMPOSITION, AND EXPOSURES OF COUNTRY RISK AND EVALUATING THE ADEQUACY OF COUNTRY-RISK MANAGEMENT

Apart from the consideration of the creditworthiness of individual borrowers, holding companies engaged in international activities are subject to elements of country risk. Country risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country, as well as the governmental policies structured to respond to these conditions. These factors may have potentially favorable or adverse consequences for foreigners' debt and equity investments in a particular country. The Federal Reserve, along with the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, have issued supervisory guidance concerning the elements of an effective country-risk management process for banking organizations. (See SR-02-05 and SR-08-12, including their attachments.)

Country risk is the risk that economic, social, or political conditions in a foreign country might adversely affect an organization's financial condition, primarily through impaired credit quality or transfer risk.[2] Country risk is also an important consideration when evaluating the level of credit risk associated with individual counterparties in a country. Regardless of the availability of foreign exchange, macroeconomic conditions and events that are beyond the control of individual borrowers can strain or impair the financial capacity of otherwise sound borrowers. Significant depreciation of a country's exchange rate, for example, increases the cost of servicing external debt and can adversely affect not only transfer risk for the country, but also the credit risk associated with even the strongest counterparties in the country.

Country risk can occur in many different forms, and the nature of specific risks can change over time. It is essential that a U.S. banking organization with significant direct or indirect international exposure have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. More specifically, country risk focuses on a borrower's capacity to obtain the foreign exchange required to service cross-currency debt. A borrower's debt-service capacity may also be affected by the risks of political and social upheaval, nationalization and expropriation, governmental repudiation of external indebtedness, exchange controls, and devaluation. Events such as these may materially affect the condition of investments and the profitability of lending activities overseas; examiners must alert management to those risks that may be difficult for the holding company and its subsidiaries to absorb.

Using uniform examination procedures and techniques for evaluating country-risk exposures for domestic banks, examiners segregate country-risk factors from the evaluation of other lending risks. The procedures emphasize diversification of exposure to individual countries as the primary method of moderating country risk in international portfolios. The approach generally consists of three parts:

1. measuring exposure in each country where a business relationship exists
2. analyzing exposure in relation to the bank's capital resources and the economic and financial conditions of each country in which the bank has outstanding credits
3. evaluating the risk-management system used by the bank in relation to the size and nature of its foreign lending activities

Examiners should evaluate the adequacy of the country-risk management process at internationally active bank holding companies. This risk-assessment process should include, at a

1. With the adoption of revised ICERC procedures in November 2008, the Federal Reserve and the other banking agencies eliminated the rating categories of Other Transfer Risk Problems, Weak, Moderately Strong, and Strong.

2. Transfer risk is the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on the availability of, needed foreign exchange in the country of the obligor. For more information, see the "Guide to the Interagency Country Exposure Review Committee Process" (SR-08-12's attachment).

minimum, effective oversight by the board of directors, adequate risk-management policies and procedures, an accurate country-exposure reporting system, an effective country-risk analysis process, a country-risk rating system, country-exposure limits, ongoing monitoring of country conditions, periodic stress testing of foreign exposures, and adequate internal controls and an audit function. A bank holding company's country-risk management process should give particular attention to any concentrations of country risk, first at the consolidated level and then within the parent company and nonbank subsidiaries, as well as to any concentrations reported by supervisors at the bank subsidiaries.

4090.0.1 COUNTRY RISKS AND FACTORS

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

4090.0.1.1 Macroeconomic Factors

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

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

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

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

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

1. the country's access to international financial markets and the potential effects of a loss of market liquidity;
2. the country's relationships with private-sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country;
3. the country's current standing with multilateral and official creditors, including the ability of the country to qualify for and sustain an International Monetary Fund or other suitable economic adjustment program;
4. the trend in foreign investments and the country's ability to attract foreign investments in the future; and
5. the opportunities for privatization of government-owned entities.

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

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

4090.0.1.2 Social, Political, and Legal Climate

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

1. the country's natural- and human-resource potential;
2. the willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action;
3. the degree to which political or regional factionalism or armed conflicts are adversely affecting the government of the country;
4. any trends toward government-imposed price, interest-rate, or exchange controls;
5. the degree to which the country's legal system can be relied on to fairly protect the interests of foreign creditors and investors;
6. the accounting standards in the country and the reliability and transparency of financial information;
7. the extent to which the country's laws and government policies protect parties in electronic transactions and promote the development of technology in a safe and sound manner;
8. the extent to which government policies promote the effective management of the bank holding company's exposures; and
9. the level of adherence to international legal and business-practice standards.

4090.0.1.3 Factors Specific to Banking Organizations

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

1. the bank holding company's business strategy and its exposure-management plans for the country;
2. the mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio;
3. the economic outlook for any specifically targeted industries within the country;
4. the degree to which political or economic developments in a country are likely to affect the bank holding company's chosen lines of business in the country (for instance, the unemployment rate or changes in local bankruptcy laws may affect certain activities more than others);
5. for a bank holding company involved in capital markets, its susceptibility to changes in value based on market movements (As the market value of claims against a foreign counterparty rise, the counterparty may become less financially sound, thus increasing the risk of nonpayment (this is especially true for over-the-counter derivative instruments.));
6. the degree to which political or economic developments are likely to affect the credit risk of individual counterparties in the country (for example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country); and
7. the bank holding company's ability to effectively manage its exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.

4090.0.2 RISK-MANAGEMENT PROCESS FOR COUNTRY RISK

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

ally active bank holding companies, and they should regularly update their assessments. A bank holding company's country-risk management process should give particular attention to any concentrations of country risk at the parent level or within its bank and nonbank subsidiaries.

Country risk is not necessarily limited to banking organizations with direct international exposures. Domestic counterparties with significant economic dependence on a foreign country or region (for example, through export dependence) can pose an indirect country risk to banking organizations that do not have direct international activity. While banking organizations are not required to incorporate indirect country risk into a formal country-risk management process, they should, nevertheless, take these country-risk factors into account, where appropriate, when assessing the creditworthiness of domestic counterparties. Examiners should ensure that the overall credit-risk management process takes into account indirect country risk where applicable in all Federal Reserve–supervised banking organizations.

To effectively control the risk associated with international activities, bank holding companies must have a risk-management process that focuses on the broadly defined concept of country risk. The elements of a sound country-risk management process are discussed in further detail below.

4090.0.2.1 Oversight by the Board of Directors

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

4090.0.2.2 Policies and Procedures for Managing Country Risk

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

1. establish risk-tolerance limits;
2. delineate clear lines of responsibility and accountability for country-risk management decisions;
3. specify authorized activities, investments, and instruments; and
4. identify both desirable and undesirable types of business.

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

4090.0.2.3 Country-Exposure Reporting System

To effectively manage country risk, the bank holding company must have a reliable system for capturing and categorizing the volume and nature of foreign exposures. The reporting system should cover all aspects of the bank holding company's operations, whether conducted through paper transactions or electronically. An accurate country-exposure reporting system is also necessary to support the regulatory reporting of foreign exposures on the quarterly Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a.

The board of directors should regularly receive reports on the level of foreign exposures. If the level of foreign exposures in a bank holding company is significant,[3] or if a country to which the bank holding company is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when a deterioration in foreign exposures would threaten the soundness of the bank holding company.

3. For purposes of this guidance, concentrations of exposures to individual countries that exceed 25 percent of the bank holding company's or bank's tier 1 capital plus the ALLL are considered significant. However, in the case of particularly troubled countries, lesser degrees of exposure may also be considered to be significant.

4090.0.2.4 Country-Risk Analysis Process

Although the nature of the country-risk analysis process and the level of resources devoted to it will vary, depending on the size and sophistication of the banking organization's international operations, a number of considerations are relevant to evaluating the process in all banking organizations:

1. Is there a quantitative and qualitative assessment of the risk associated with each country in which the banking organization is conducting or planning to conduct business?
2. Is a formal analysis of country risk conducted at least annually, and does the banking organization have an effective system for monitoring developments in the interim?
3. Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the banking organization may have targeted in its business strategy?
4. Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the banking organization's exposures in a country?
5. Given the size and sophistication of the banking organization's international activities, are the resources devoted to the analysis of country risk adequate?
6. As a final check of the process, are the banking organization's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?

4090.0.2.5 Country-Risk Ratings

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

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

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

A banking organization's country-risk ratings may differ from the ICERC-assigned transfer-risk ratings because the two ratings differ in purpose and scope. A banking organization's internally assigned ratings help it to decide whether to extend additional credit, as well as how it should manage existing exposures. Such ratings should, therefore, have a forward-looking and broad country-risk focus. The ICERC's more narrowly focused transfer-risk ratings are primarily a supervisory tool to identify countries where concentrations of transfer risk might warrant greater scrutiny and to determine whether some minimum level of reserves against transfer risk should be established. The ICERC rating process only rates countries in default. Default occurs when a country is not complying with its external debt-service obligations or is unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest fully and on time, arrearages, forced restructuring, or rollovers. For more information on ICERC ratings, see section 7040.3 of the *Commercial Bank Examination Manual* and SR-08-12.

4090.0.2.6 Country-Exposure Limits

As part of their country-risk management process, internationally active bank holding companies should adopt a system of country-exposure limits. Because the limit-setting process often involves divergent interests within the banking organization (such as the country managers, the bank holding company's overall country-risk manager, and the country-risk committee), country-risk limits will usually

reflect a balancing of several considerations, including—

1. the overall strategy guiding the bank holding company's international activities,
2. the country's risk rating and the bank holding company's appetite for risk,
3. perceived business opportunities in the country, and
4. the desire to support the international business needs of domestic customers.

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

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

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

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

4090.0.2.7 Monitoring Country Conditions

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

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

4090.0.2.8 Stress Testing

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

4090.0.2.9 Internal Controls and Audit

Bank holding companies should ensure that their country-risk management process includes adequate internal controls and that an audit

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

4090.0.3 REPORTING REQUIREMENTS

4090.0.3.1 Country Exposure Report (FFIEC 009)

Banks and bank holding companies required to file the Country Exposure Report (Form FFIEC 009, formerly Form FR 2036) when the bank or banks have a foreign branch, a foreign subsidiary, or an Edge corporation, and when they have, on a consolidated basis, total outstanding claims on residents of foreign countries of $30 million or more. The report is to be filed quarterly within 45 days of the end of March, June, September, and December.

The report measures lending to residents of foreign countries by U.S. banking organizations. It is used to provide information on the distribution, by country, of foreign claims held by such banking organizations to (1) determine the degree of risk in bank portfolios and how adverse developments in particular countries affect the U.S. banking system; (2) assess country risk for supervisory purposes, and (3) assist the Bank for International Settlements in compiling worldwide data on cross-border claims. The report also includes information on revaluation gains for off-balance-sheet items and for securities held in trading accounts.

4090.0.3.2 Country Exposure Information Report (FFIEC 009a)

The County Exposure Information Report (Form FFIEC 009a) supplements the Country Exposure Report. The purpose of FFIEC 009a is to provide public disclosure of significant country exposures of U.S. banking institutions. Every institution that submits the FFIEC 009 and that has exposures to a country that exceed 1 percent of total assets or 20 percent of capital of the reporting institution submits the FFIEC 009a. FFIEC 009a respondents also furnish a list of countries in which exposures were between ¾ of 1 percent and 1 percent of total assets or between 15 and 20 percent of capital. Filing of the report is required.

4090.0.3.3 Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (FFIEC 019)

The Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (Form FFIEC 019) is similar to the FFIEC 009 report that is filed by U.S. banks. The FFIEC 019 report collects information, by country, on the direct claims, indirect claims, and total adjusted claims on foreign residents; information on direct claims on related non–U.S. offices domiciled in countries other than the home country of the parent bank that are ultimately guaranteed in the home country that are included in total adjusted claims on the home country; and information on the breakdown of adjusted claims on unrelated foreign residents. The data are used by the supervisory agencies to monitor significant foreign-country exposures of U.S. branches and agencies of foreign banks. The reports are also used to evaluate the financial condition of these branches and agencies.

The FFIEC 019 is collected quarterly from those branches and agencies of foreign banks that have, as of the quarterly report date, more than $30 million in total direct claims on residents of foreign countries. The FFIEC 019 provides data on the foreign-risk exposure of each reporting branch and agency.

Respondents to the FFIEC 019 must prepare the data as of the close of each calendar quarter and submit the forms to the appropriate Reserve Bank no later than 45 days following the report date. Data are due at the Board 60 days following the report date. Bank holding companies should obtain, from the management of their respective foreign bank subsidiaries, written confirmation that the FFIEC 019 and all other Federal Reserve and FFIEC reports have been filed, as required.

4090.0.4 INSPECTION OBJECTIVES

1. If the bank holding company is internationally active, to determine the nature and extent of its direct and indirect country-risk exposures.
2. If the bank holding company has significant

direct or indirect international exposure, to evaluate and determine whether it has in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities.

3. To review and determine if the bank holding company's system of policies, procedures, internal controls, rating system, and stress testing for county-risk management are adequate and reliable.
4. To determine if the bank holding company's board of directors oversees and regularly reviews its country-risk management process, approves limits on country exposure, provides for adequate capital that is commensurate with its direct and indirect country-risk exposures, and ensures that management is effectively controlling the risk.
5. To determine if management clearly communicates the bank holding company's country-risk management policies, standards, and practices to the affected offices and staff.
6. To (1) determine if the scope of the bank holding company's audit function is adequate and if the function is sufficiently comprehensive to ensure the integrity of the information senior management and the board use to monitor the bank holding company's country-risk management process, and (2) ensure that the board of directors or its audit committee has provided for adequate audit coverage of country-risk management functions.
7. To recommend corrective action if a bank holding company's country-risk management process and controls are deficient in relation to the level of country-risk exposure.
8. To determine if the bank holding company is properly preparing the Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a, both of which are required to be filed quarterly with the respective Reserve Banks, as applicable.
9. To identify and report individual exposures considered significant in relation to the bank holding company's capital and the economic performance of the country.
10. To prepare a report on the bank holding company's country-exposure management system and on any noted deficiencies.

4090.0.5 INSPECTION PROCEDURES

When performing and updating the bank holding company's risk assessment, the central point of contact for the bank holding company should include an analysis of its direct and indirect country-risk exposures (including any significant country-risk concentrations) and of the adequacy and reliability of its country-risk management. The analysis of the bank holding company's country-risk management systems should consist of three important components.

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

In the second component, the board of directors and senior management define the level of country exposure the bank is willing to assume. This undertaking normally includes the establishment of limits on aggregate outstandings, maturities, and categories of risk exposures by country, which serve as a guide to operating management in the development and servicing of the bank holding company's international credit portfolio.

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

A summary of the country-risk management system should be prepared. Set forth below are guidelines and procedures for examiners to use in evaluating the systems banks use to monitor and control country-risk elements in their international loan portfolios. In assessing the quality of the country-risk management system, examiners should, as a matter of course, spot-check the accuracy of the data submitted on the Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a, as applicable. The review should include a review of the exposures for at least several countries. The report page, Examiners' Comments and Matters Requiring Special Board

Attention, should be used to comment on material exceptions.

1. Obtain any written policies, procedures, or summaries of the bank holding company's country-risk management system. Determine whether the bank holding company's country-risk management system includes—
   a. effective oversight by the board of directors,
   b. adequate risk-management policies and procedures,
   c. an accurate country-exposure reporting system,
   d. an effective country-risk analysis process,
   e. a country-risk rating system,
   f. country-exposure limits,
   g. ongoing monitoring of country conditions,
   h. periodic stress testing of foreign exposures, and
   i. adequate internal controls and an audit function. (See SR-02-05.)
2. Review international-lending policies and determine—
   a. if the board of directors regularly reviews and gives final approval to the limits on country exposure at least annually (or quarterly, if the foreign exposures are high risk or the concentrations are significant);
   b. who initiates the country ratings and country limits;
   c. how frequently and by whom country ratings and limits are reviewed and changed;
   d. how the bank holding company defines the ratings assigned to the various countries;
   e. how country limits are determined;
   f. who is responsible for monitoring compliance with country limits;
   g. if country-risk limits consider—
      (1) the overall strategy guiding the institution's international activities,
      (2) the country's risk rating and the institution's appetite for risk,
      (3) perceived business opportunities in the country, and
      (4) the desire to support the international business needs of domestic customers;
   h. to what extent country limits are viewed as guidelines that may be exceeded;
   i. if the bank holding company has different sublimits for private- and public-sector credits;
   j. if separate limits are established for private- and public-sector credits;
   k. if the board of directors or a committee thereof periodically reviews country ratings and limits, and evaluates the bank holding company's performance against those standards;
   l. to what extent comments or classifications of bank supervisors are considered in establishing, increasing, or decreasing country limits;
   m. how the system has been changed since the last examination;
   n. if the bank holding company has a reliable system for capturing and categorizing the volume and nature of foreign exposures;
   o. whether the bank holding company has a system to monitor current conditions in each of the countries where it is significantly exposed;
   p. if there is regular, ongoing communication between senior management and the responsible country managers;
   q. if established procedures are in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country; and
   r. whether the bank holding company periodically conducts stress tests (financial modeling or measuring the impact of various scenarios on its country-risk profiles) of its foreign exposures, and if the results are reported to senior management and the board of directors.
3. Review reports furnished to the board or the appropriate committee to ensure that comprehensive and accurate information is being submitted on a timely basis.
4. Obtain the bank holding company's report on the general distribution and characteristics of the international loan portfolio and compare loan-category distributions for adherence to guidelines.
5. During a discussion with senior management, direct inquiries to—
   a. gain insight into general management's international-lending philosophy, and
   b. elicit management's responses for correction of deficiencies.
6. When reporting on the bank holding company's country-risk management system, consider factors such as—
   a. the quality of internal policies, practices, procedures, and controls over the international-lending functions;
   b. the scope and adequacy of the internal

loan-review system as it pertains to country risk;
c. causes of existing problems;
d. commitments from management for correction of deficiencies;
e. expectations for continued sound international lending or correction of existing deficiencies;
f. the ability of management to monitor and control transfer risk;
g. the general level of adherence to internal policies, practices, procedures, and controls; and
h. the scope and adequacy of the bank holding company's analysis of country conditions.