Deposits are funds that customers place with a bank and that the bank is obligated to repay on demand, after a specific period of time or after expiration of some required notice period. Deposits are the primary funding source for most banks and, as a result, have a significant effect on a bank’s liquidity. Banks use deposits in a variety of ways, primarily to fund loans and investments. Management should establish a procedure for determining the volatility and composition of the deposit structure to ensure that funds are employed profitably, while allowing for their potential withdrawal. Therefore, a bank’s management should implement programs to retain and prudently expand the bank’s deposit base.

Bankers place great significance on the deposit structure because favorable operating results depend, in part, on a core deposit base. Because of competition for funds, the need for most individuals and corporations to minimize idle funds, and the effect of disintermediation (the movement of deposits to other higher-yielding markets) on a bank’s deposit base, bank management should adopt and implement a development and retention program for all types of deposits.

DEPOSIT DEVELOPMENT AND RETENTION PROGRAM

Important elements of the examination process are the review of a bank’s deposit development and retention program and the methods used to determine the volatility and composition of the deposit structure. A bank’s deposit development and retention program should include—

• a marketing strategy,
• projections of deposit structure and associated costs, and
• a formula for comparing results against projections.

To structure a deposit program properly, bank management must consider many factors, some of which include—

• the composition of the market-area economic base,
• the ability to employ deposits profitably,
• the adequacy of current operations (staffing and systems) and the location and size of banking quarters relative to the bank’s volume of business,
• the degree of competition from banks and nonbank financial institutions and their programs to attract deposit customers, and
• the effects of the national economy and the monetary and fiscal policies of the federal government on the bank’s service area.

The bank’s size and the composition of its market determine how formal its deposit program should be. After a bank develops its deposit program, management must continue to monitor the above factors and correlate any findings to determine if adjustments are needed. The long-term success of any deposit program relates directly to the ability of management to make adjustments at the earliest possible time.

DEPOSIT STRUCTURE

Management should look not only at deposit growth but also at the nature of the deposit structure. To invest deposited funds properly in view of anticipated or potential withdrawals, management must be able to determine what percentage of the overall deposit structure is centered in core deposits, in fluctuating or seasonal deposits, and in volatile deposits. It is important that internal reports with information concerning the composition of the deposit structure be provided to management periodically. Management’s lack of such knowledge could lead to an asset-liability mismatch, causing problems at a later date.

In analyzing the deposit structure, information gathered by the various examination procedures should be sufficient to allow the examiner to evaluate the composition of both volatile and core deposits. Ultimately, the examiner should be satisfied with management’s efforts to plan for the bank’s future.

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

COST OF FUNDS

Interest paid on deposits is generally the largest expense to a bank. As a result, interest-bearing deposit accounts employed in a marginally profitable manner could have significant and lasting effects on bank earnings. The examiner should consider the following in evaluating the effect of interest-bearing deposit accounts on a bank’s earnings:

• an estimated change in interest expense resulting from a change in interest rates on deposit accounts or a shift in funds from one type of account to another
• service-charge income
• projected operating costs
• changes in required reserves
• promotional and advertising costs
• the quality of management’s planning

SPECIAL DEPOSIT-RELATED ISSUES

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

Abandoned-Property Law

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

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

Service charges on dormant accounts should bear a direct relationship to the cost of servicing the accounts, which ensures that the charges are not excessive. A bank’s board of directors (or a committee appointed by the board) should review the basis on which service charges on dormant accounts are assessed and should document the review. There have been occasions when excessive servicing charges have resulted in no proceeds being remitted at the time the account became subject to escheat requirements. In these cases, courts have required banks to reimburse the state. (See also the “Dormant Accounts” discussion later in this section.)

Bank Secrecy Act

Examiners should be aware of the Bank Secrecy Act when examining the deposit area and should follow up on any unusual activities or arrangements noted. The act was implemented by the Treasury Department’s Financial Recordkeeping and Reporting of Currency and Foreign Transactions Regulation. For further information, see the FFIEC Bank Secrecy Act Examination Manual, section 208.63 of the Federal Reserve’s Regulation H, and the Financial Crimes Enforcement Network (FinCEN)’s Bank Secrecy Act regulations at 31 CFR Chapter X. Prior to March 1, 2011, FinCEN’s regulation was at 31 CFR 103.

Banking Hours and Processing of Demand Deposits

The Board’s Regulation CC (12 CFR 229), “Availability of Funds and Collection of Checks,” and the Uniform Commercial Code (UCC) govern banking-day cutoff hours and the processing of deposits. A “banking day” is that part of a day on which an office of the bank is open to the public for carrying out substantially all of its banking functions. Saturdays, Sundays, and certain specified holidays are not banking days under Regulation CC, although such days might be banking days under the UCC if a bank is open for substantially all of its functions on those days.

Regulation CC requires a bank to make deposited funds available for withdrawal within a certain period after the banking day on which they are received. Cash deposits, wire transfers, and certain check deposits that pose little risk to the depositary bank (such as Treasury checks and cashier’s checks) generally are to be made available for withdrawal by the business day.
after the day of deposit. The time when the depository bank must make other check deposits available for withdrawal depends on whether the check is local or nonlocal to the depository bank. As of September 1, 1990, proceeds of local and nonlocal checks must be available for withdrawal by the second and fifth business day following deposit, respectively. However, Regulation CC allows a bank to set, within certain limits, cutoff hours, after which the bank will deem funds to be received on the next banking day for purposes of calculating the availability date (12 CFR 229.19). Different cutoff-hour limits apply to different types of deposits.

For the purpose of allowing banks to process checks, the UCC provides that a bank may set a cutoff hour of 2 p.m. or later and that items received after that time will be considered received as of the next banking day (UCC section 4-108). Under both the UCC and Regulation CC, both the banking day on which a bank is deemed to have received a check and the cutoff hour affect the time frames within which a bank must send the check through the forward-collection and return processes.

A bank that fails to set its cutoff hour appropriately, does not make funds available within the appropriate time frames, or processes checks in an untimely manner may be subject to civil liability for not performing its duties in accordance with various provisions of Regulation CC and the UCC.

Banking Accounts for Foreign Governments, Embassies, Missions, and Political Figures

On June 15, 2004, an interagency advisory concerning the embassy banking business and related banking matters was issued by the federal banking and thrift agencies (the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration (the agencies)). The advisory was issued in coordination with the U.S. Department of the Treasury’s Financial Crimes Enforcement Network. The purpose of the advisory is to provide general guidance to banking organizations regarding the treatment of accounts for foreign governments, foreign embassies, and foreign political figures.

The joint interagency statement advises banking organizations that the decision to accept or reject an embassy or foreign government account is theirs alone to make. The statement advises that financial institutions should be aware that there are varying degrees of risk associated with such accounts, depending on the customer and the nature of the services provided. Institutions should take appropriate steps to manage such risks consistent with sound practices and applicable anti-money-laundering laws and regulations. The advisory also encourages banking organizations to direct questions about embassy banking to their primary federal bank regulators. (See SR-04-10.)

On March 24, 2011, an interagency advisory was issued to supplement SR-04-10, “Banking Accounts for Foreign Governments, Embassies, and Political Figures.” The supplemental advisory provides information to financial institutions regarding the provision of account services to foreign embassies, consulates and to foreign missions in a manner that fulfills the needs of those foreign governments while complying with the provisions of the Bank Secrecy Act (BSA). It advises that financial institutions are expected to demonstrate the capacity to conduct appropriate risk assessments and implement the requisite controls and oversight systems to effectively manage the risk identified in these relationships with foreign missions. The advisory also confirms that it is the financial institution’s decision to accept or reject a foreign mission account. (See SR-11-6 and the attached supplemental interagency advisory.)

Interagency Advisory on Accessing Accounts from Foreign Governments, Embassies, and Foreign Political Figures

The 2004 interagency advisory answers questions on whether financial institutions should conduct business with foreign embassies and whether institutions should establish account services for foreign governments, foreign embassies, and foreign political figures. As it would with any new account, an institution should evaluate whether or not to accept a new account for a foreign government, embassy, or political figure. That decision should be made by the institution’s management, under standards and guidelines established by the board of directors, and should be based on the institution’s own business objectives, its assessment of the risks
associated with particular accounts or lines of business, and its capacity to manage those risks. The agencies will not, in the absence of extraordinary circumstances, direct or encourage any institution to open, close, or refuse a particular account or relationship.

Providing financial services to foreign governments and embassies and to foreign political figures can, depending on the nature of the customer and the services provided, involve varying degrees of risk. Such services can range from account relationships that enable an embassy to handle the payment of operational expenses, for example, payroll, rent, and utilities, to ancillary services or accounts provided to embassy staff or foreign government officials. Each of these relationships potentially poses different levels of risk. Institutions are expected to assess the risks involved in any such relationships and to take steps to ensure both that such risks are appropriately managed and that the institution can do so in full compliance with its obligations under the BSA, as amended by the USA Patriot Act, and the regulations promulgated thereunder.

When an institution elects to establish financial relationships with foreign governments, embassies, or foreign political figures, the agencies, consistent with their usual practice of risk-based supervision, will make their own assessment of the risks involved in such business. As is the case with all accounts, the institution should expect appropriate scrutiny by examiners that is commensurate with the level of risk presented by the account relationship. As in any case where higher risks are presented, the institution should expect an increased level of review by examiners to ensure that the institution has in place controls and compliance oversight systems that are adequate to monitor and manage such risks, as well as personnel trained in the management of such risks and in the requirements of applicable laws and regulations.

Institutions that have or are considering taking on relationships with foreign governments, embassies, or political figures should ensure that such customers are aware of the requirements of U.S. laws and regulations to which the institution is subject. Institutions should, to the maximum extent feasible, seek to structure such relationships in order to conform them to conventional U.S. domestic banking relationships so as to reduce the risks that might be presented by such relationships.

Foreign-Currency Deposits

Domestic depository institutions are permitted to accept deposits denominated in foreign currency. Institutions should notify customers that such deposits are subject to foreign-exchange risk. The bank should convert such accounts to the U.S. dollar equivalent for purposes of reporting to the Federal Reserve. Examination staff should ascertain that all reports are in order and should evaluate the bank’s use of such funds and its management of the accompanying foreign-exchange risk. Accounts denominated in foreign currency are not subject to the requirements of Regulation CC. (See SR-90-03 (IB), “Foreign (Non–U.S.) Currency Denominated Deposits Offered at Domestic Depository Institutions.”)

International Banking Facilities

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

Deposits Insured by the Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC) is an independent agency of the U.S. government. The FDIC protects depositors against the loss of their insured deposits due to the failure of an insured bank, savings bank, savings association, insured branch of a foreign bank, or other depository institution whose deposits are insured pursuant to the Federal Deposit Insurance Corporation Act. If a depositor’s accounts at one FDIC-insured depository institution total up to $250,000 (or the standard maximum deposit insurance amount [SMDIA]), the funds are fully insured and protected. A depositor can have more than the SMDIA at one insured depository institution and still be fully insured provided the accounts meet certain requirements. In addition, federal law currently
provides for insurance coverage of up to $250,000 or the SMDIA.

The FDIC insurance covers all types of deposits received at an insured depository institution, including deposits in checking, negotiable order of withdrawal (NOW), and savings accounts; money market deposit accounts; and time deposits such as certificates of deposit (CDs). FDIC deposit insurance covers the balance of each depositor’s account, dollar-for-dollar, up to the SMDIA, including the principal and any accrued interest through the date of an insured depository institution’s closing.

Deposits in separate branches of an insured depository institution are not separately insured. Deposits in one insured institution are insured separately from deposits in another insured institution. Deposits maintained in different categories of legal ownership at the same depository institution can be separately insured. Therefore, it is possible to have deposits of more than the SMDIA at one insured institution and still be fully insured.

Deposit Insurance Reform Acts

On March 14, 2006, the FDIC amended its deposit insurance regulations (effective April 1, 2006) by issuing an interim rule with a request for public comment on or before May 22, 2006. (See 71 Fed. Reg. 14631, 71 Fed. Reg. 53550 (Sept. 12, 2006) and 12 CFR Part 330.) The interim rule implemented applicable revisions to the Federal Deposit Insurance Act made by the Federal Deposit Insurance Reform Act of 2005 (Reform Act) and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (the Conforming Amendments Act). The Reform Act provided for consideration of inflation adjustments (cost-of-living adjustment) to increase the current SMDIA on a five-year cycle beginning on April 1, 2010.

Second, the Reform Act increased the deposit insurance limit for accounts up to $250,000, also subject to inflation adjustments. The types of accounts included are individual retirement accounts (IRAs), 1 eligible deferred compensation plan accounts, 2 and individual account plans, and any plan described in section 401(d) of the IRC, to the extent that participants and beneficiaries under such plans have a right to direct the investment of assets held in individual accounts maintained on their behalf by the plans.

Third, the Reform Act provided per-participant insurance coverage to employee benefit plan accounts, even if the depository institution at which the deposits are placed is not authorized to accept employee benefit plan deposits. The cost-of-living adjustment is to be calculated according to the Personal Consumption Expenditures Chain-type Price Index published by the U.S. Department of Commerce and rounded down to the nearest $10,000.

The Conforming Amendments Act created the term “government depositor” in connection with public funds described in and insured pursuant to section 11(a)(2) of the Federal Deposit Insurance Act (FDIA). (See 12 USC 1821(a)(2).) The Conforming Amendments Act provides that the deposits of a government depositor are insured in an amount up to the SMDIA, subject to the inflation adjustment described previously.

Deposit Insurance Rule Amendments

Retirement and Employee Benefit Plan Accounts

When deposits from a retirement or employee benefit plan (EBP)—such as a 401(k) retirement account, Keogh plan account, corporate pension plan, or profit-sharing program—are entitled to pass-through insurance, the SMDIA on FDIC insurance does not apply to the entire EBP account balance. Rather, the FDIC insurance coverage “passes through” to each owner or beneficiary, and the deposited funds of each individual EBP participant are insured up to the SMDIA.

The Reform Act and the Conforming Amendments Act, and the FDIC’s March 23, 2006, interim rule eliminated the previous requirement that pass-through coverage for employee benefit plan accounts be dependent on the capital level of a depository institution where such deposits are placed. Pass-through coverage for employee benefit plan deposits was not available if the

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1. IRAs described in section 408(a) of the Internal Revenue Code (IRC). (See 26 USC 408(a).)
2. Eligible deferred compensation plan accounts described in section 457 of the IRC. (See 26 USC 457.)
3. Individual account plan accounts such as those defined in section 3(34) of the Employee Retirement Income Security Act.

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deposits were placed with an institution that was not permitted to accept brokered deposits because of the capital requirements. Insured institutions that are not “well capitalized” or “adequately capitalized” are now prohibited by the Reform Act from accepting employee benefit plan deposits. Under the Reform Act, employee benefit plan deposits accepted by an insured depository institution, even those prohibited from accepting such deposits, are nonetheless eligible for pass-through deposit insurance coverage. The rule’s amendment (see 12 CFR 330.14) applies to all employee benefit plan deposits, including employee benefit plan deposits placed before April 1, 2006. The rule’s other requirements in section 330.14 continue to apply. In particular, only the “noncontingent” interests of plan participants in an applicable plan are eligible for pass-through coverage. A “noncontingent interest” is an interest that can be determined without the evaluation of contingencies other than life expectancy. The maximum coverage for accounts is up to $250,000 or the SMDIA. These accounts continue to be made up of individual retirement accounts (the traditional IRAs and the Roth IRAs); section 457 deferred compensation plan accounts, “self-directed” Keogh plan accounts (or HR 10 accounts); and “self-directed” defined contribution plan accounts, which are primarily 401(k) plan accounts. The term self-directed means that the plan participants have the right to direct how their funds are invested, including the ability to direct that the funds be invested at an FDIC-insured institution.

Reserve Requirements

The Monetary Control Act of 1980 and the Federal Reserve’s Regulation D, “Reserve Requirements of Depository Institutions,” establish two categories of deposits for reserve-requirement purposes. The first category is the transaction account, which represents a deposit or account from which the depositor or account holder is permitted to make orders of withdrawals by negotiable instrument, payment orders of withdrawal, telephone transfer, or similar devices for making payments to a third party or others. Transaction accounts include demand deposits, NOW accounts, automatic transfer (ATS) accounts, and telephone or preauthorized transfer accounts. The second category is the non-transaction deposit account, which includes all deposits that are not transaction accounts, such as (1) savings deposits, that is, money market deposit accounts and other savings deposits, and (2) time deposits, that is, time certificates of deposit and time deposits, open account. See Regulation D for specific definitions of the various deposit accounts.

Treasury Tax and Loan Accounts

Member banks may select either the “remittance-option” or the “note-option” method to forward deposited funds to the U.S. Treasury. With the remittance option, the bank remits the Treasury Tax and Loan (TT&L) account deposits to the Federal Reserve Bank the next business day after deposit. The remittance portion is not interest-bearing.

The note option permits the bank to retain the TT&L deposits. With the note option, the bank debits the TT&L remittance account for the amount of the previous day’s deposit and simultaneously credits the note-option account. Thus, TT&L funds are now purchased funds evidenced by an interest-bearing, variable-rate, open-ended, secured note callable on demand by Treasury. Rates paid are 1/4 of 1 percent less than the average weekly rate on federal funds. Interest is calculated on the weekly average daily closing balance in the TT&L note-option account. Although there is no required maximum note-option ceiling, banks may establish a maximum balance by providing written notice to the Federal Reserve Bank. As per 31 CFR 203.24, the TT&L balance requires the bank to pledge collateral to secure these accounts, usually from its investment portfolio. The note option is not included in reserve-requirement computations and is not subject to deposit insurance because it is classified as a demand note issued to the U.S. Treasury, a type of borrowing.

POTENTIAL PROBLEM AREAS

The following types of deposit accounts and related activities have above-average risk and, therefore, require the examiner’s special attention.
Bank-Controlled Deposit Accounts

Bank-controlled deposit accounts, such as suspense, official checks, cash-collateral, dealer reserves, and undisbursed loan proceeds, are used to perform many necessary banking functions. However, the absence of sound administrative policies and adequate internal controls can cause significant loss to the bank. To ensure that such accounts are properly administered and controlled, the directorate must ensure that operating policies and procedures are in effect that establish acceptable purpose and use; appropriate entries; controls over posting entries; and the length of time an item may remain unrecorded, unposted, or outstanding. Internal controls that limit employee access to bank-controlled accounts, determine the responsibility for frequency of reconcilement, discourage improper posting of items, and provide for periodic internal supervisory review of account activity are essential to efficient deposit administration.

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

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

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

Brokered Deposits

As defined in Federal Deposit Insurance Corporation (FDIC) regulations, brokered deposits are funds a depository institution obtains, directly or indirectly, from or through the mediation or assistance of a deposit broker, for deposit into one or more deposit accounts (12 CFR 337.6). Thus, brokered deposits include both those in which the entire beneficial interest in a given bank deposit account or instrument is held by a single depositor and those in which the deposit broker pools funds from more than one investor for deposit in a given bank deposit account.

Section 29 of the Federal Deposit Insurance Act (the FDI Act) (12 USC 1831f(g)(1)) and the FDIC’s regulations (12 CFR 337.6 (a)(5)) define deposit broker to mean—

- any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and
- an agent or a trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.

The term deposit broker does not include —

- an insured depository institution, with respect to funds placed with that depository institution;
- an employee of an insured depository institution, with respect to funds placed with the employing depository institution;
- a trust department of an insured depository institution, if the trust or other fiduciary relationship in question has not been established for the primary purpose of placing funds with insured depository institutions;
- the trustee of a pension or other employee benefit plan, with respect to funds of the plan;
• a person acting as a plan administrator or an investment adviser in connection with a pension plan or other employee benefit plan provided that person is performing managerial functions with respect to the plan;
• the trustee of a testamentary account;
• the trustee of an irrevocable trust, as long as the trust in question has not been established for the primary purpose of placing funds with insured depository institutions;
• a trustee or custodian of a pension or profit-sharing plan qualified under section 401(d) or 403(a) of the Internal Revenue Code of 1986 (26 USC 401(d), 503(a)); or
• an agent or a nominee whose primary purpose is not the placement of funds with depository institutions; or
• an insured depository institution acting as an intermediary or agent of a U.S. government department or agency for a government-sponsored minority or women-owned depository institution deposit program.

A small- or medium-sized bank’s dependence on the deposits of customers who reside or conduct their business outside of the bank’s normal service area should be closely monitored by the bank and analyzed by the examiner. Such deposits may be the product of personal relationships or good customer service; however, large out-of-area deposits are sometimes attracted by liberal credit accommodations or significantly higher interest rates than competitors offer. Deposit growth that is due to liberal credit accommodations generally proves costly in terms of the credit risks taken relative to the benefits received from corresponding deposits, which may be less stable. Banks outside dynamic metropolitan areas are limited in growth because they usually can maintain stable deposit growth only as a result of prudent reinvestment in the bank’s service area. Deposit development and retention policies should recognize the limits imposed by prudent competition and the bank’s service area.

Historically, most banking organizations have not relied on funds obtained through deposit brokers to supplement their traditional funding sources. A concern regarding the activities of deposit brokers is that the ready availability of large amounts of funds through the issuance of insured obligations undercuts market discipline.

The use of brokered deposits by sound, well-managed banks can play a legitimate role in the asset-liability management of a bank and enhance the efficiency of financial markets. However, the use of brokered deposits also can contribute to the weakening of a bank by allowing it to grow at an unmanageable or imprudent pace and can exacerbate the condition of a troubled bank. Consequently, without proper monitoring and management, brokered and other highly rate-sensitive deposits, such as those obtained through the Internet, certificate of deposit (CD) listing services, and similar advertising programs, may be unstable sources of funding for an institution.

Deposits attracted over the Internet, through CD listing services, or through special advertising programs offering premium rates to customers without another banking relationship, require special monitoring. Although these deposits may not fall within the technical definition of “brokered” in 12 USC 1831f and 12 CFR 337.6, their inherent risk characteristics are similar to brokered deposits. That is, such deposits are typically attractive to rate-sensitive customers who may not have significant loyalty to the bank. Extensive reliance on funding products of this type, especially those obtained from outside a bank’s geographic market area, has the potential to weaken a bank’s funding position.

Some banks have used brokered and Internet-based funding to support rapid growth in loans and other assets. In accordance with the safety-and-soundness standards, a bank’s asset growth should be prudent and its management must consider the source, volatility, and use of the funds generated to support asset growth. (See 12 CFR 208 appendix D-1.)

To compensate for the high rates typically offered for brokered deposits, institutions holding them tend to seek assets that carry commensurately high yields. These assets can often involve excessive credit risk or cause the bank to take on undue interest-rate risk through a mismatch in the maturity of assets and liabilities. The FDI Act (12 USC 1831f) includes certain restrictions on the use of brokered deposits to prohibit undercapitalized insured depository institutions from accepting funds obtained, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts.

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4. This exception does not apply to an agent or a trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.
Capital Categories

For the purposes of section 29 of the FDI Act, the regulations of the FDIC and the Federal Reserve (for the FDIC, 12 CFR 325.103 and for the Federal Reserve, 12 CFR 208.43) provide the definitions of well-capitalized, adequately capitalized, and undercapitalized financial institutions (banks). These definitions are tied to percentages of leverage and risk-based capital. Section 29 of the FDI Act limits the rates of interest on brokered deposits that may be offered by insured depository institutions that are adequately capitalized or undercapitalized.

Well-capitalized bank. A bank is deemed to be well capitalized if it—

- has a total risk-based capital ratio of 10.0 percent or greater;
- has a tier 1 risk-based capital ratio of 6.0 percent or greater;
- has a leverage ratio of 5.0 percent or greater; and
- is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board pursuant to section 8 of the FDI Act (12 USC 1818), the International Lending Supervision Act of 1983 (12 USC 3907), or section 38 of the FDI Act (12 USC 1831o), or any regulation thereunder, to meet and maintain a specific capital level for any capital measure.

A well-capitalized insured depository institution may solicit and accept, renew, or roll over any brokered deposit without restriction.

Adequately capitalized bank. A bank is deemed to be adequately capitalized if it—

- has a total risk-based capital ratio of 8.0 percent or greater;
- has a tier 1 risk-based capital ratio of 4.0 percent or greater;
- has a leverage ratio of 4.0 percent or greater; and
- is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board pursuant to section 8 of the FDI Act (12 USC 1818), the International Lending Supervision Act of 1983 (12 USC 3907), or section 38 of the FDI Act (12 USC 1831o), or any regulation thereunder, to meet and maintain a specific capital level for any capital measure.

An adequately capitalized insured depository institution may not accept, renew, or roll over any brokered deposit unless it has applied for and been granted a waiver of this prohibition by the FDIC. If the insured depository institution has been granted a waiver by the FDIC, the institution may accept, renew, or roll over a brokered deposit. The institution may not pay an effective yield on the deposit that exceeds, by more than 75 basis points: (1) the effective yield paid on deposits of comparable size and maturity, and for deposits accepted, within the institution’s normal market area or (2) the “national rate” paid on deposits of comparable size and maturity for deposits accepted outside the institution’s normal market area. The national rate is either 120 or 130 basis points of the current yield on similar-maturity U.S. Treasury obligations, depending on whether the deposit is FDIC insured or more than half uninsured (the portion of the deposit that is in excess of the FDIC-insured limit, as detailed in the rule).

If an FDIC-insured bank is adequately capitalized and does not have a waiver from the FDIC, it may not use a broker to obtain deposits. The following rate restrictions on deposits also apply: (1) the deposit rates may be no more than 75 basis points over the effective yield on deposits of comparable size and maturity within the bank’s normal market area and (2) the deposit rates may not be based on a “national” rate.

Undercapitalized bank. A bank is deemed to be undercapitalized if it—

- has a total risk-based capital ratio that is less than 8.0 percent;
- has a tier 1 risk-based capital ratio that is less than 4.0 percent;
- has a leverage ratio that is less than 4.0 percent; or
- has a leverage ratio that is less than 3.0 percent.

5. For deposits obtained through Internet solicitations, the determination of the bank’s “normal market area” is particularly problematic and difficult.

6. An exception is available when (1) the bank the (the insured depository institution) has a leverage ratio of 3.0 percent or greater, (2) the bank is rated composite 1 under the CAMELS rating system following its most-recent bank examination, and (3) the bank is not experiencing or anticipating significant growth.
cent, if the bank is rated composite 1 under the CAMELS rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth.

An undercapitalized insured depository institution may not accept, renew, or roll over any brokered deposit. Also, an undercapitalized insured depository institution (and any employee of the institution) may not solicit deposits by offering an effective yield that exceeds by more than 75 basis points the prevailing effective yields on insured deposits of comparable maturity in the institution’s normal market area or in the market area in which such deposits are being solicited.

Each examination should include a review for compliance with the FDIC’s limitations on the acceptance of brokered deposits and guidelines on interest payments. The use of brokered deposits should be reviewed during all on-site examinations, even in those institutions not subject to the FDIC’s restrictions. Given the potential risks involved in using brokered deposits, the examination should focus on the—

• rate of growth and the credit quality of the loans or investments funded by brokered deposits;
• corresponding quality of loan files, documentation, and customer credit information;
• ability of bank management to adequately evaluate and administer these credits and manage the resulting growth;
• degree of interest-rate risk involved in the funding activities and the existence of a possible mismatch in the maturity or rate sensitivity of assets and liabilities;
• composition and stability of the deposit sources and the role of brokered deposits in the bank’s overall funding position and strategy; and
• effect of brokered deposits on the bank’s financial condition and whether the use of brokered deposits constitutes an unsafe and unsound banking practice.

The examiner should identify relevant concerns in the examination report when brokered deposits amount to 5 percent or more of the bank’s total deposits.

Risk-Management Expectations for Brokered Deposits

On May 11, 2001, the Federal Reserve Board and the other federal banking agencies (the agencies) issued a Joint Agency Advisory on Brokered and Rate-Sensitive Deposits. The advisory sets forth the following risk-management guidelines for brokered deposits. The bank’s management is expected to implement risk-management systems that are commensurate in complexity with the liquidity and funding risks that the bank undertakes. (See SR-01-14.) Such systems should incorporate the following principles:

• **Proper funds-management policies.** A good policy should generally provide for forward planning, establish an appropriate cost structure, and set realistic limitations and business strategies. It should clearly convey the board’s risk tolerance and should not be ambiguous about who holds responsibility for funds-management decisions.

• **Adequate due diligence when assessing deposit brokers.** Bank management should implement adequate due diligence procedures before entering any business relationship with a deposit broker. The agencies do not regulate deposit brokers.

• **Due diligence in assessing the potential risk to earnings and capital associated with brokered or other rate-sensitive deposits, and prudent strategies for their use.** Bankers should manage highly sensitive funding sources carefully, avoiding excessive reliance on funds that may be only temporarily available or which may require premium rates to retain.

• **Reasonable control structures to limit funding concentrations.** Limit structures should consider typical behavioral patterns for depositors or investors and be designed to control excessive reliance on any significant source(s) or type of funding. This includes brokered funds and other rate-sensitive or credit-sensitive deposits obtained through the Internet or other types of advertising.

• **Management information systems (MIS) that clearly identify nonrelationship or higher-cost funding programs and allow management to track performance, manage funding gaps, and monitor compliance with concentration and...**
other risk limits. At a minimum, MIS should include a listing of funds obtained through each significant program, rates paid on each instrument and an average per program, information on maturity of the instruments, and concentration or other limit monitoring and reporting. Management also should ensure that brokered deposits are properly reported in the bank’s Consolidated Reports of Condition and Income.7

Contingency funding plans that address the risk that these deposits may not “roll over” and provide a reasonable alternative funding strategy. Contingency funding plans should factor in the potential for changes in market acceptance if reduced rates are offered on rate-sensitive deposits. The potential for triggering legal limitations that restrict the bank’s access to brokered deposits under Prompt Corrective Action (PCA) standards, and the effect that this would have on the bank’s liability structure, should also be factored into the plan.

Examiners should assess carefully the liquidity-risk management framework at all banks. Banks with meaningful reliance on brokered or other rate-sensitive deposits should receive the appropriate level of supervisory attention. Examiners should not wait for PCA provisions to be triggered or the viability of the bank to come into question, before raising relevant safety-and-soundness issues with regard to the use of these funding sources. If a determination is made that a bank’s use of these funding sources is not safe and sound, or that these risks are excessive or that they adversely affect the bank’s condition, then the examiner or central point of contact should recommend to the Reserve Bank management that it consider taking immediate appropriate supervisory action. The following represent potential red flags that may indicate the need to take such action to ensure the risks associated with brokered or other rate-sensitive funding sources are managed appropriately:

- ineffective management or the absence of appropriate expertise
- a newly chartered institution with few relationship deposits and an aggressive growth strategy
- inadequate internal audit coverage
- inadequate information systems or controls
- identified or suspected fraud
- high on- or off-balance-sheet growth rates
- use of rate-sensitive funds not in keeping with the bank’s strategy
- inadequate consideration of risk, with management focus exclusively on rates
- significant funding shifts from traditional funding sources
- the absence of adequate policy limitations on these kinds of funding sources
- high loan delinquency rate or deterioration in other asset-quality indicators
- deterioration in the general financial condition of the institution
- other conditions or circumstances warranting the need for administrative action

Check Kiting

Check kiting occurs when—

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

The key to this deceptive practice, the most prevalent type of check fraud, is the ability to draw against uncollected funds. However, drawing against uncollected funds in and of itself does not necessarily indicate kiting. Kiting only occurs when the aggregate amount of drawings exceeds the sum of the collected balances in all accounts. Nevertheless, since drawing against uncollected funds is the initial step in the kiting process, management should closely monitor this activity. The requirements of Regulation CC, Availability of Funds and Collection of Checks, increased the risk of check kiting, and should be addressed in a bank’s policies and procedures.

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

**Delayed Disbursement Practices**

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

Delayed disbursement arrangements could give rise to supervisory concerns because a bank may unknowingly incur significant credit risk through such arrangements. The remote location of institutions offering delayed disbursement arrangements often increases the collection time for checks by at least a day. The primary risk is payment against uncollected funds, which could be a method of extending unsecured credit to a depositor. Absent proper and complete documentation regarding the creditworthiness of the depositor, paying items against uncollected funds could be considered an unsafe or unsound banking practice. Furthermore, such loans, even if properly documented, might exceed the bank’s legal lending limit for loans to one customer.

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

**Deposit Sweep Programs or Master-Note Arrangements**

Deposit sweep programs or master-note arrangements (sweep programs) can be implemented on a bank level or on a parent bank holding company (BHC) level. On a bank level, these sweep programs exist primarily to facilitate the cash-management needs of bank customers, thereby retaining customers who might otherwise move their account to an entity offering higher yields. On a BHC level, the sweep programs are maintained with customers at the bank level, and the funds are upstreamed to the parent as part of the BHC’s funding strategy. Sweep programs use an agreement with the bank’s deposit customers (typically corporate accounts) that permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent bank holding company, another affiliate of the bank, or a third party. These obligations include instruments such as commercial paper, program notes, and master-note agreements. (See SR-90-31.)

The disclosure agreement regarding the sale of the nondeposit debt obligations should include a statement indicating that these instruments are not federally insured deposits or obligations of or guaranteed by an insured depository institution. In addition, banks and their subsidiaries that have issued or plan to issue nondeposit debt obligations should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank. This requirement exists to convey the impression or understanding that the purchase of such obligations by retail depositors of the subsidiary bank can, in the event of default, result in losses to individuals who believed they had acquired federally insured or guaranteed obligations.

**Bank Policies and Procedures**

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

Application of Deposit Proceeds

In view of the extremely short-term maturity of most swept funds, banks and BHCs are expected to exercise great care when investing the proceeds. Banks, from whom deposit funds are swept, have a fiduciary responsibility to their customers to ensure that such transactions are conducted properly. Appropriate uses of the proceeds of deposit sweep funds are limited to short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal. When deposit sweep funds are invested in U.S. government securities, appropriate agreements must be in place, required disclosures must be made, and daily confirmations must be provided to the customer in accordance with the requirements of the Government Securities Act of 1986. Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity problems and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

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

Funding Strategies

A key principle underlying the Federal Reserve's supervision of banking organizations is that BHCs operate in a way that promotes the soundness of their subsidiary banks. BHCs are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Any funding strategy should maintain an adequate degree of liquidity at both the parent level and the subsidiary bank level. Bank management should avoid, to the extent possible, allowing sweep programs to serve as a source of funds for inappropriate uses at the BHC or at an affiliate. Concerns exist in this regard because funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in a banking organization's viability.

Funding Programs

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

Dormant Accounts

A dormant account is one in which customer-originated activity has not occurred for a predetermined period of time. Because of this inactivity, dormant accounts are frequently the target of malfeasance and should be carefully controlled by a bank. Bank management should establish standards that specifically outline the bank's policy for the effective control of dormant accounts, addressing—

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

Employee Deposit Accounts
Historically, examiners have discovered various irregularities and potential malfeasance through review of employee deposit accounts. As a result, bank policy should establish standards that segregate or specially encode employee accounts and should encourage periodic internal supervisory review. In light of these concerns, examiners should review related bank procedures and practices, taking appropriate measures when warranted.

Overdrafts
The size, frequency, and duration of deposit-account overdrafts are matters that should be governed by bank policy and controlled by adequate internal controls, practices, and procedures. Overdraft authority should be approved in the same manner as lending authority and should never exceed the employee’s lending authority. Systems for monitoring and reporting overdrafts should emphasize a secondary level of administrative control that is distinct from other lending functions so account officers who are less than objective do not allow influential customers to exploit their overdraft privileges. A bank’s payment of overdrafts of executive officers and directors of the bank is generally prohibited under Regulation O. (See 12 CFR 215.4(e).) It is the board of directors’ responsibility to review overdrafts as they would any other extension of credit. Overdrafts outstanding for more than 60 days, lacking mitigating circumstances, should be considered for charge-off. See SR-05-3/CA-05-2 and section 2130.1 on the February 18, 2005, Interagency Joint Guidance on Overdraft Protection Programs.

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

Public Funds
Public funds generally represent deposits of the U.S. government, as well as state and political subdivisions, and typically require collateral in the form of securities to be pledged against them. A bank’s reliance upon public funds can cause potential liquidity concerns if the aggregate amount, as a percentage of total deposits, is material relative to the bank’s asset-liability management practices. Another factor that can cause potential liquidity concerns relates to the volatile nature of these deposits. This volatility occurs because the volume of public funds normally fluctuates on a seasonal basis due to timing differences between tax collections and expenditures. A bank’s ability to attract public funds is typically based upon the government entity’s assessment of three key points:
• the safety and soundness of the institution with which the funds have been placed
• the yield on the funds being deposited
• that such deposits are placed with a bank that can provide or arrange the best banking service at the least cost

Additionally, banks that offer competitive interest rates and provide collection, financial advisory, underwriting, and data processing services at competitive costs are frequently chosen as depositories. Public funds deposits acquired
through political influence should be regarded as particularly volatile. As a result, an examiner should pay particular attention to assessing the volatility of such funds in conjunction with the review of liquidity.

Zero-Balance Accounts

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

- wire transfers;
- depository transfer checks, a bank-prepared payment instrument used to transfer money from a corporate account in one bank to another bank;
- concentration accounts, a separate corporate demand deposit account at the same bank used to cover deficits or channel surplus funds relative to the ZBA; or
- extended settlement, a cash-management arrangement that does not require the corporate customer to provide same-day funds for payment of its checks.

Because checks are covered before the close of business on the day they arrive, the bank’s exposure is not reflected in the financial statement. The bank, however, assumes risk by paying against uncollected funds, thereby creating unsecured extensions of credit during the day (which is referred to as a daylight overdraft between the account holder and the bank). If these checks are not covered, an overdraft occurs, which will be reflected on the bank’s financial statement.

The absence of prudent safeguards and a lack of full knowledge of the creditworthiness of the depositor may expose the bank to large, unwarranted, and unnecessary risks. Moreover, the magnitude of unsecured credit risk may exceed prudent limits. Examiners should routinely review cash-management policies and procedures to ensure that banks do not engage in unsafe and unsound banking practices, making appropriate comments in the report of examination, as necessary.
Deposit Accounts
Examination Objectives
Effective date November 2006

1. To determine if the policies, practices, procedures, and internal controls regarding deposit accounts are adequate.
2. To determine if the bank’s management implemented adequate risk-management systems for brokered and rate-sensitive deposits that are commensurate with the liquidity and funding risks the bank has undertaken.
3. To determine if the bank’s policies, practices, procedures, and internal controls (including compliance oversight, management reporting, and staff training) for account relationships involving foreign governments, foreign embassies, and foreign political figures (as well as foreign-currency customer deposit accounts) are adequate for the varied risks posed by these accounts.
4. To determine if bank officers and employees are operating in conformance with the bank’s established guidelines.
5. To evaluate the deposit structure and determine its characteristics and volatility.
6. To determine the scope and adequacy of the audit function.
7. To determine compliance with applicable laws and regulations.
8. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations are noted.
Deposit Accounts
Examination Procedures
Effective date April 2012

1. Determine the scope of the examination of the deposit-taking function. In so doing, consider the findings of prior examinations, related work prepared by internal and external auditors, deficiencies in internal controls noted within other bank functions, and the requirements of examiners assigned to review the asset/liability management and interest-rate risk aspects of the bank.

2. If required by the scope, implement the “Deposit Accounts” internal control questionnaire.

3. Test the deposit function for compliance with policies, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest internal or external audit review, then determine if appropriate corrections have been made.

4. In conducting the examination, use available bank copies of printouts plus transactions journals or other visual media to minimize expense to the bank. However, if copies of these reports are not available, determine what information is necessary to complete the examination procedures and request that information from the bank.

Obtain or prepare, as applicable, the reports indicated below, which are used for a variety of purposes, including the assessment of deposit volatility and liquidity, the assessment of the adequacy of internal controls, the verification of information on required regulatory reports, and the assessment of loss.

- For demand deposits and other transaction accounts:
  - trial balance
  - overdrafts
  - unposted items
  - nonsufficient-funds (NSF) report
  - dormant accounts
  - public funds
  - uncollected funds
  - due to banks
  - trust department funds
  - significant activity
  - suspected kiting report
- matured certificates of deposit without an automatic renewal feature
- large-balance report

- For official checks:
  - trial balance(s)
  - exception list

- For savings accounts:
  - trial balance
  - unposted items
  - overdrafts
  - dormant accounts
  - public funds
  - trust department funds
  - large-balance report

- For other time deposits:
  - trial balance(s)
  - large-balance report
  - unposted items
  - public funds
  - trust department funds
  - money market accounts

- For certificates of deposit:
  - trial balance(s)
  - unposted items
  - public funds
  - certificates of $100,000 or more
  - negotiable certificates of deposit
  - maturity reports
  - matured certificates of deposit

- For deposit sweep programs or master-note arrangements, list individually by deposit type and amount.

- For brokered deposits, list individually by deposit type, including amount and rate.

- For bank-controlled accounts:
  - reconcilement records for all such accounts
  - names and extensions of individuals authorized to make entries to such accounts
  - name and phone extension of reconcilement clerk(s)

- For the bank’s foreign-currency customer deposit accounts and the deposit accounts for foreign governments, embassies, and political figures:
  - list of accounts and currency type
  - list of currency transactions over $10,000 for each account, and the copies of their Currency Transaction Commercial Bank Examination Manual

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Report or its equivalent, since the previous examination (See 31 CFR 1010.330 and its examples.)

- the most recent internal audit report covering the review of those accounts, the risks associated with the accounts, the internal controls over those accounts, and the staff’s completion of the Currency Transaction Report
- the completed copies of the Report of Foreign (Non-U.S.) Currency Deposits, Form 2915, that have been submitted since the previous examination

5. Review the reconcilement of all types of deposit accounts. Verify the balances to department controls and the general ledger.
   a. Determine if reconciliation items are legitimate and if they clear within a reasonable time frame.
   b. Retain custody of all trial balances until items outstanding are resolved.

6. Review the reconciliation process for bank-controlled accounts, such as official checks and escrow deposits, by—
   a. determining if reconciling items are legitimate and if they clear within a reasonable time frame;
   b. scanning activity in such accounts to determine the potential for improper diversion of funds for various uses, such as—
      • political contributions,
      • loan payments (principal and interest), or
      • personal use; and
   c. determining if checks are being processed before their related credits.

7. Review the bank’s operating procedures and reconciliation process relative to suspense accounts. Determine if—
   a. the disposition process of unidentified items is completed in a timely fashion;
   b. reports are generated periodically to inform management of the type, age, and amount of items in such accounts; and
   c. employees responsible for clearing suspense-account items are not shifting the items between accounts.

8. Evaluate the effectiveness of the written policies and procedures and of management’s reporting methods regarding overdrafts and drawings against uncollected funds.
   a. Concerning overdrafts, determine if—
      • officer-approval limits have been established, and
      • a formal system of review and approval is in effect.
   b. Determine whether the depository institution has an overdraft-protection program and if it has adequate written policies and procedures to address the credit, operational, and other risks associated with those programs. See the February 18, 2005, interagency Joint Guidance on Overdraft Protection Programs (SR-05-3/CA-05-2). If the bank provides overdraft protection, perform the following procedures:
      • Obtain a master list of all depositors with formal overdraft protection.
      • Obtain a trial balance indicating advances outstanding and compare it with the master list to ensure compliance with approved limits.
      • Cross-reference the trial balance or master list to examiner loan line sheets.
      • Review credit files on significant formal agreements not cross-referenced above.
      • Ascertain whether there is ongoing monitoring of overdrafts to identify customers who may pose an undue credit risk to the bank.
      • Find out if the bank has incorporated into its overdraft-protection program prudent risk-management practices pertaining to account repayment and the suspension of a customer’s overdraft-protection services when the customer does not satisfy repayment and eligibility requirements.
      • Determine whether overdrafts are properly and accurately reported according to generally accepted accounting principles on the bank’s financial statements and on its Reports of Condition and Income (Call Reports). Verify that overdrafts are reported as loans on the Report of Condition.
      • Verify the existence of the bank’s loss-estimation procedures for overdraft and fee balances. Determine if the procedures are adequately rigorous and if losses are properly accounted for as part of (1) the allowance for loan and lease losses (ALLL) or (2) the loss allowance for uncollectible fees (alternatively, the bank may recognize only
that portion of earned fees estimated to be collectible), if applicable.

- When applicable, validate (1) whether the bank's overdraft commitments have been assigned the correct conversion factor, (2) whether they are accurately risk-weighted by obligor, and (3) if the commitment terms comply with the risk-based capital guidelines.
- Determine whether the bank has obtained assurances from its legal counsel that its overdraft-protection program is fully compliant with all applicable federal and state laws and regulations, including the Federal Trade Commission Act.
- When the bank contracts with third-party vendors to do information technology work, determine if the bank conducted proper due diligence before entering into the contract and that it followed the November 28, 2000, guidance on the Risk Management of Outsourced Technology Services. (See SR-00-17.)

9. Review the bank's deposit development and retention policy, which is often included in the funds-management policy.
   a. Determine if the policy addresses the deposit structure and related interest costs, including the percentages of time deposits and demand deposits of—
      • individuals,
      • corporations, and
      • public entities.
   b. Determine if the policy requires periodic reports to management comparing the accuracy of projections with results.
   c. Assess the reasonableness of the policy, and ensure that it is routinely reviewed by management.

10. If a deposit sweep program or master-note arrangement exists, review the minutes of the board of directors for approval of related policies and procedures.
11. For banks with deposit sweep programs or master-note arrangements (sweep programs), compare practices for adherence to approved policies and procedures. Review the following:
   a. The purpose of the sweep program: Is it strictly a customer-accommodation transaction, or is it intended to fund certain assets at the holding company level or at an affiliate? Review funding transactions in light of liquidity and funding needs of the banking organization by referring to section 4020.1.
   b. The eligibility requirements used by the bank to determine the types of customers and accounts that may participate in a sweep program, including—
      • a list of customers participating in
sweep programs, with dollar amounts of deposit funds swept on the date of examination, and
• the name of the recipient(s) of swept funds.
  — If the recipient is an affiliate of the bank, include a schedule of the instruments into which the funds were swept, including the effective maturity of these instruments.
  — If the recipient is an unaffiliated third party, determine if the bank adequately evaluates the third party’s financial condition at least annually. Also, verify if a fee is received by the bank for the transaction. If so, determine that the fee is disclosed in customer documentation.

c. Whether the proceeds of sweep programs are invested only in short-term bank obligations; short-term U.S. government securities; or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.

d. Whether the bank and its subsidiaries have issued or plan to issue nondeposit debt obligations in any public area of the bank where retail deposits are accepted, including any lobby area of the bank.

e. Completed sweep-program documents to determine the following:
  • Signed documents boldly disclose that the instrument into which deposit funds will be swept is not insured by the FDIC and is not an obligation of, or guaranteed by, the bank.
  • Proper authorization for the instrument exists between the customer and an authorized representative of the bank.
  • Signed documents properly disclose the name of the obligor and the type of instrument into which the depositor’s funds will be swept. If funds are being swept into U.S. government securities held by the banking organization, verify that adequate confirmations are provided to customers in accordance with the Government Securities Act of 1986. (This act requires that all transactions subject to a repurchase agreement be confirmed in writing at the end of the day of initiation and that the confirmation confirms specific securities. If any other securities are substituted that result in a change of issuer, maturity date, par amount, or coupon rate, another confirmation must be issued at the end of the day during which the substitution occurred. Because the confirmation or safekeeping receipt must list specific securities, “pooling” of securities for any type of sweep program involving government securities is not permitted. Additionally, if funds are swept into other instruments, similar confirmation procedures should be applied.)
  • Conditions of the sweep program are stated clearly, including the dollar amount (minimum or maximum amounts and incremental amounts), time frame of sweep, time of day the sweep transaction occurs, fees payable, transaction confirmation notice, prepayment terms, and termination notice.
  • The length of any single transaction under sweep programs in effect has not exceeded 270 days and the amount is $25,000 or more (as stipulated by SEC policy). Ongoing sweep-program disclosures should occasionally be sent to the customer to ensure that the terms of the program are updated and the customer understands the terms.

f. Samples of advertisements (newspaper, radio, television spots, etc.) by the bank for sweep programs to determine if the advertisements—
  • boldly disclose that the instrument into which deposit funds are swept is not insured by the FDIC and is not an obligation of, or guaranteed by, the bank, and
  • are not enclosed with insured deposit statements mailed to customers.

g. Whether the sweep program has had a negative effect on bank liquidity or has the potential to undermine public confidence in the bank.
  • Review the bank’s federal funds and borrowing activities to ascertain whether borrowings appear high. If so, compare the bank’s borrowing activity with daily balances of aggregate sweep transactions on selected dates to see if a correlation exists.
• If sweep activity is significant, compare the rates being paid on swept deposits with the yields received on the invested funds and with the rates on other overnight funding instruments, such as federal funds, to determine if they are reasonable.

12. Forward the following to the examiner assigned to asset/liability management:
   a. the amount of any deposit decline or deposit increase anticipated by management (the time period will be determined by the examiner performing asset/liability management)
   b. a listing by name and amount of any depositor controlling more than 1 percent of total deposits
   c. a listing, if available, by name and amount of any deposits held solely because of premium rates paid (brokered deposits)
   d. the aggregate amount of brokered deposits
   e. a maturity schedule of certificates of deposit, detailing maturities within the next 30, 60, 90, 180, and 360 days
   f. an assessment of the overall characteristics and volatility of the deposit structure

13. Analyze UBPR data on deposits and related expense ratios, and compare with peer-group norms to determine—
   a. variations from the norm, and
   b. trends in the deposit structure with respect to—
   • growth patterns, and
   • shifts between deposit categories.

14. Assess the volatility and the composition of the bank’s deposit structure.
   a. Review the list of time certificates of deposit of $100,000 or more and related management reports, including those on brokered deposits, to determine—
   • whether concentrations of maturing deposits exist;
   • whether a concentration of deposits to a single entity exists;
   • the aggregate dollar volume of accounts of depositors outside the bank’s normal service area, if significant, and the geographic areas from which any significant volume emanates;
   • the aggregate dollar volume of CDs that have interest rates higher than current publicly quoted rates within the market;
   • whether the bank is paying current market rates on CDs;
   • the dollar amount of brokered CDs, if any; and
   • the dollar volume of deposits obtained as a result of special promotions.

   • If the bank is undercapitalized, as defined in the FDIC’s regulation on brokered deposits, ensure that it is not accepting brokered deposits. (See 12 CFR 337.6.)
   • If the bank is only adequately capitalized, as defined in the FDIC’s regulation and is accepting brokered deposits, ensure that a waiver authorizing acceptance of such deposits has been obtained from the FDIC and that the bank is in compliance with the interest-rate restrictions. (See 12 CFR 337.6(b)(2) and (3).)
   c. Determine if the bank has risk-management systems to monitor and control its liquidity and funding risks that are associated with the bank’s brokered and rate-sensitive deposits.
   d. Ascertain if the bank’s risk-management systems for its brokered and rate-sensitive deposits are adequate and if they are commensurate with the complexity of its liquidity and funding risks. Determine if the bank has the following:
   • proper funds-management policies;
   • adequate due diligence when assessing the risks associated with deposit brokers;
   • due diligence in assessing the potential risk to earnings and capital associated with brokered or other rate-sensitive deposits, and prudent strategies for their use;
   • reasonable control structures to limit funding concentrations;
   • management information systems (MIS) that clearly identify nonrelationship or higher-cost funding programs that allow management to track performance, manage funding gaps, and monitor compliance with concentration and other risk limits; and
   • contingency funding plans that address the risk that these deposits may
not “roll over” and provide a reasonable alternative funding strategy.
e. Review public funds and the bank’s method of acquiring such funds to assess whether the bank uses competitive bidding in setting the interest rate paid on public deposits. If so, does the bank consider variables in addition to rates paid by competition in determining pricing for bidding on public deposits?
f. Review appropriate trial balances for all other deposits (demand, savings, and other time deposits). Review management reports that relate to large deposits for individuals, partnerships, corporations, and related deposit accounts to determine whether a deposit concentration exists.
   • Select, at a minimum, the 10 largest accounts to determine if the retention of those accounts depends on—
     — criticizable loan relationships;
     — liberal service accommodations, such as permissive overdrafts and drawings against uncollected funds;
     — interbank correspondent relationships;
     — deposits obtained as a result of special promotions; and
     — a recognizable trend with respect to—
       • frequent significant balance fluctuations,
       • seasonal fluctuations, and
       • nonseasonal increases or decreases in average balances.
g. Elicit management’s comments to determine, to the extent possible—
   • the potential renewal of large CDs that mature within the next 12 months;
   • if public fund deposits have been obtained through political influence;
   • if a significant dollar volume of accounts is concentrated in customers engaged in a single business or industry; and
   • if there is a significant dollar volume of deposits from customers who do not reside within the bank’s service area.
15. Obtain information on competitive pressures and economic conditions and evaluate that information, along with current deposit trends, to estimate its effect on the bank’s deposit structure.
16. Perform the following procedures to test for compliance with the applicable laws and regulations listed below:
a. Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks. Review the overdraft listing to ensure that the bank has not paid an overdraft on any account of an executive officer or director, unless the payment is made according to—
   • a written, preauthorized, interest-bearing extension of a credit plan that provides a method of repayment, or
   • a written, preauthorized transfer from another account of that executive officer or director.
   Payment of inadvertent overdrafts in an aggregate amount of $1,000 or less is not prohibited, provided the account is not overdrawn more than five business days and the executive officer or director is charged the same fee charged to other customers in similar circumstances. Overdrafts are extensions of credit and must be included when considering each insider’s lending limits and other extension-of-credit restrictions, as well as when considering the aggregate lending limit for all outstanding extensions of credit by the bank to all insiders and their related interests.
b. 12 USC 1972(2), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks. Review the overdraft listing to ensure that no preferential overdrafts exist from the bank under examination to the executive officers, directors, or principal shareholders of the correspondent bank.
c. Section 22(e) of the Federal Reserve Act (12 USC 376), Interest on Deposits of Directors, Officers, and Employees. Obtain a list of deposit accounts, with account numbers, of directors, officers, attorneys, and employees. Review the accounts for any exceptions to standard policies on service charges and interest rates paid that would suggest self-dealing or preferential treatment.
d. Sections 23A and 23B of the Federal Reserve Act (12 USC 371c), and Regulation W. Determine the existence of any non-intraday overdrawn affiliate accounts. If such overdrawn accounts are identified, review for compliance with.getPath
sections 23A and 23B of the act and with Regulation W.
e. Regulation D (12 CFR 204), Reserve Requirements of Depository Institutions. Review the accuracy of the deposit data used in the bank’s reserve-requirement calculation for the examination date. When a bank issues nondeposit, uninsured obligations that are classified as “deposits” in the calculation of reserve requirements, examiners should determine if these items are properly categorized. Ascertain that the TT&L remittance option is included in the computations for reserve requirements.
f. 12 USC 501 and 18 USC 1004, False Certification of Checks. Compare several certified checks by date, amount, and purchaser with the depositors’ names appearing on uncollected-funds and overdraft reports of the same dates to determine that the checks were certified against collected funds.
g. Uniform Commercial Code 4-108, Banking Hours and Processing of Items.
   • Determine the bank’s cutoff hour, after which items received are included in the processing for the next “banking day,” to ensure that the cutoff hour is not earlier than 2:00 p.m.
   • If the bank’s cutoff hour is before 2:00 p.m., advise management that failure to process items received before a 2:00 p.m. cutoff may result in civil liability for delayed handling of those items.
h. Local escheat laws. Determine if the bank is adhering to the local escheat laws with regard to all forms of dormant deposits, including official checks.

17. If applicable, determine if the bank is appropriately monitoring and limiting the foreign-exchange risk associated with foreign-currency deposits.

18. For a bank that accepts accounts from foreign governments, embassies, and political figures, evaluate—
   a. the existence and effectiveness of the bank’s policies, procedures, compliance oversight, and management reporting with regard to such foreign accounts;
   b. whether the bank and its staff have the necessary controls, as well as the ability, to manage the risks associated with such foreign accounts;
   c. whether the bank’s board of directors and staff can ensure full compliance with its obligations under the Bank Secrecy Act, as amended by the USA Patriot Act, and its regulations;
   d. the adequacy of the level of training of the bank’s personnel responsible for managing the risks associated with such foreign accounts and for ensuring that the bank is and remains in compliance with the requirements of the applicable laws and regulations; and
   e. the effectiveness of the bank’s program that communicates its policies and procedures for such foreign accounts to ensure that foreign government, embassy, and political-figure customers are fully informed of the requirements of applicable U.S. laws and regulations.

19. Discuss overall findings with bank management. Prepare report comments on—
   a. policy deficiencies,
   b. noncompliance with policies,
   c. weaknesses in supervision and reporting,
   d. violations of laws and regulations, and
   e. possible conflicts of interest.

20. Update workpapers with any information that will facilitate future examinations.
Deposit Accounts
Internal Control Questionnaire
Effective date November 2004
Section 3000.4

Review the bank’s internal controls, policies, practices, and procedures for demand and time deposit accounts. The bank’s systems should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

For large institutions or those institutions that have individual demand and time deposit bookkeeping functions, the examiner should consider administering this questionnaire separately for each function, as applicable.

Questions pertain to both demand and time deposits unless otherwise indicated. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

OPENING DEPOSIT ACCOUNTS

*1. Are new-account documents prenumbered?
   a. Are new-account documents issued in strict numerical sequence?
   b. Are the opening of new accounts and access to unused new-account records and certificate of deposit (CD) forms handled by an employee who is not a teller or who cannot make internal entries to customer accounts or the general ledger?

*2. Does the institution have a written “know-your-customer” policy?
   a. Do new-account applications require sufficient information to clearly identify the customer?
   b. Are “starter” checks issued only after the verification of data on new transaction-account applications?
   c. Are checkbooks and statements mailed only to the address of record? If not, is a satisfactory explanation and description obtained for any other mailing address (post office boxes, a friend or relative, etc.)?
   d. Are the employees responsible for opening new accounts trained to screen depositors for signs of check kiting?

*3. Does the bank perform periodic inventories of new-account documents and CDs, and do the inventories include accountability of numbers issued out of sequence or canceled prior to issuance?

*4. Are CDs signed by a properly authorized individual?

5. Are new-account applications and signature cards reviewed by an officer?

CLOSING DEPOSIT ACCOUNTS

1. Are signature cards for closed accounts promptly pulled from the active-account file and placed in a closed file?

2. Are closed-account lists prepared? If so, how frequently?

3. Is the closed-account list circulated to appropriate management?

4. Is verification of closed accounts, in the form of statements of “goodwill” letters, required? Are such letters mailed under the control of someone other than a teller or an individual who can make internal entries to an account (such as a private banker or branch manager)?

*5. For redeemed CDs:
   a. Are the CDs stamped paid?
   b. Is the disposition of proceeds documented to provide a permanent record as well as a clear audit trail?
   c. Are penalty calculations on CDs and on other time deposits that are redeemed before maturity rechecked by a second employee?

*6. Except for deposit-account agreements that authorize the transfer of deposited funds to other nondemand deposit accounts, are matured CDs that are not automatically renewable classified as demand deposits on the Call Report and on the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900)?

DEPOSIT-ACCOUNT RECORDS

*1. Does the institution have documentation supporting a current reconciliation of each deposit-account category recorded on its general ledger, including customer accounts...
and bank-controlled accounts such as dealer reserves, escrow, Treasury tax and loan, etc.? (Prepare separate workpapers for demand and time accounts, listing each account and the date and frequency of reconcilement, the general-ledger balance, the subsidiary-ledger balance, adjustments, and unexplained differences.)

*2. Are reconciliations performed by an individual or group not directly engaged in accepting or preparing transactions or in data entry to customers’ accounts?

*3. If the size of the bank precludes full separation of duties between data entry and reconcilement, are reconcilement duties rotated on a formal basis, and is a record maintained to support such action?

*4. Are reconciliations reviewed by appropriate independent management, especially in circumstances when full separation of duties is not evident?

*5. Are periodic reports prepared for management, and do the reports provide an aging of adjustments and differences and detail the status of significant adjustments and differences?

*6. Has management adequately addressed any significant or long-outstanding adjustments or differences?

*7. Is the preparation of input and the posting of subsidiary demand deposit records performed or adequately reviewed by persons who do not also—
   a. accept or generate transactions?
   b. issue official checks or handle funds-transfer transactions?
   c. prepare or authorize internal entries (return items, reversals, and direct charges, such as loan payments)?
   d. prepare supporting documents required for disbursements from an account?
   e. perform maintenance on the accounts, such as changes of address, stop payments, holds, etc.?

*8. Are in-process, suspense, interoffice, and other accounts related to deposit accounts controlled or closely monitored by persons who do not have posting or reconcilement duties?

*9. Are periodic reports prepared for management on open items in suspense and on in-process, interoffice, overdrawn, and other deposit accounts, and do the reports include aging of items and the status of significant items?

10. If the bank’s bookkeeping system is not automated, are deposit bookkeepers rotated?

11. Does the bank segregate the deposit account files of—
   a. employees and officers?
   b. directors?
   c. the business interests of employees and officers, or interests controlled by employees and officers?
   d. the business interests of directors, or interests controlled by directors?
   e. foreign governments, embassies, and political figures?

*12. Are posting and check filing separated from statement preparation?

13. Are statements mailed or delivered to all customers as required by the bank’s deposit-account agreement?

*14. Are customer transaction and interest statements mailed in a controlled environment that precludes any individual from receiving any statement not specifically authorized by the customer or the institution’s policy (for example, dormant-account statements)?

DORMANT ACCOUNTS AND RETURNED MAIL

*1. Does the bank have formal policies and procedures for the handling of customers’ transaction and interest statements that are returned as undeliverable? Does the policy—
   a. require that statements be periodically mailed on dormant accounts? If so, how often?
   b. prohibit the handling of dormant-account statements by (1) employees of the branch where the account is assigned, (2) the account officer, and (3) other individuals with exclusive control of accounts?
   c. require positive action to follow up on obtaining new addresses?
   d. place statements and signature cards for accounts for which contact cannot be re-established (the mail is returned more than once or is marked “deceased”) into a controlled environment?
   e. require the bank to change the address on future statements to the department...
of the bank (the controlled environment) designated to receive returned mail?
f. require a written request from the customer and verification of the customer's signature before releasing an account from the controlled environment?

*2. Are accounts for which contact cannot be re-established and that do not reflect recent activity removed from active files and clearly classified as dormant?

*3. Before returning a dormant account to active status, are transactions reactivating the account verified, and are independent confirmations obtained directly from the customer?

*4. Does transfer from dormant to active status require the approval of an officer who cannot approve transactions on dormant accounts?

INACTIVE ACCOUNTS

1. Are demand accounts that have been inactive for one year, and time accounts that have been inactive for three years, classified as inactive? If not, state the time period for classifying a demand or time account as inactive.

2. Does the bank periodically review the inactive accounts to determine if they should be placed in a dormant status, and are decisions to keep such accounts in active files documented?

HOLD MAIL

*1. Does the institution have a formal policy and procedure for handling statements and documents that a customer requests not to be mailed but that will be picked up at a location within the institution? Does the policy—
a. require that statements will not be held by an individual (an account officer, branch manager, bookkeeper, etc.) who could establish exclusive control over entries to and the delivery of statements for customer accounts?
b. discourage such pickup arrangements and grant them only after the customer provides a satisfactory reason for the arrangement?

c. require the customer to sign a statement describing the purpose of the request and the proposed times for pickup, and designate the individuals authorized to pick up the statement?

d. require the maintenance of signature cards for individuals authorized to pick up statements, and compare the authorized signatures with those who sign for statements held for pickup?
e. prohibit the delivery of statements to officers and employees requiring special attention unless it is part of the formal “hold-mail” function?

*2. Is a central record of hold-mail arrangements maintained in a control area that does not originate entries to customers' accounts? Does the record identify each hold-mail arrangement, the designated location for pickup, and the scheduled pickup times? Does the control area—
a. maintain current signature cards of individuals authorized to pick up statements?
b. obtain signed receipts showing the date of pickup, and compare the receipts with the signature cards?
c. follow up on the status of statements not picked up as scheduled?

*3. Does management review activity in hold-mail accounts that have not been picked up for extended periods of time (for example, one year), and, when there is no activity, place the accounts in a dormant status?

OVERDRAFTS

*1. Are overdraft authorization limits for officers formally established?

*2. Does the bank require an authorized officer to approve overdrafts?

*3. Is an overdraft listing prepared daily for demand deposit and time transaction accounts?

4. For banks processing overdrafts that are not automatically approved (a “pay none” system), is the nonsufficient-funds report circulated among bank officers?

*5. Are overdraft listings circulated among the officers?

6. Are the statements of accounts with large overdrafts reviewed for irregularities and prompt repayment?
7. Is an aged record of large overdrafts included in the monthly report to the board of directors or its committee, and does the report include the overdraft origination date?

8. Is there an established schedule of service charges?

UNCOLLECTED FUNDS

*1. Does the institution generate a daily report of drawings against uncollected funds for demand deposit and time transaction accounts?
   a. Is the computation of uncollected funds positions based on reasonable check-collection criteria?
   b. Can the reports, or a separate account activity report, be used to detect potential kiting conditions?
   c. If reports are not generated for time transaction accounts, is a system in place to control drawings against uncollected funds?

*2. Do authorized officers review the uncollected-funds reports and approve drawings against uncollected funds within established limits?

*3. Are accounts that frequently appear on the uncollected-funds or kite-suspect reports reviewed regardless of account balances? (For example, accounts with simultaneous large debits and credits can reflect low balances.)

ACCOUNTS FOR FOREIGN GOVERNMENTS, EMBASSIES, AND POLITICAL FIGURES

1. For bank relationships with a foreign government, embassy, or political figure:
   a. Has the board of directors established standards and guidelines for management to use when evaluating whether or not the bank should accept such new accounts?
   b. Are the standards and guidelines consistent with the bank’s—
      • own business objectives,
      • assessment of the varying degrees of risks associated with particular foreign accounts or lines of business, and
      • capacity to manage those risks?
   c. Does the bank have adequate internal controls and compliance oversight systems to monitor and manage the varying degrees of risks associated with such foreign accounts? Do these internal controls and compliance systems ensure full compliance with the Bank Secrecy Act, as amended by the USA Patriot Act, and its respective regulations?
   d. Does the bank have personnel that are sufficiently trained in the management of such risks and in the requirements of applicable laws and regulations?
   e. Does the bank have policies and procedures for ensuring that such foreign-account customers receive adequate communications from the bank? Communications should ensure that these customers are made fully aware of the requirements of U.S. laws and regulations to which the bank is subject.
   f. Does the bank seek to structure its relationships with such foreign-account customers so as to minimize the varying degrees of risks these customers may pose?

OTHER MATTERS

*1. Are account-maintenance activities (changes of address, status changes, rate changes, etc.) separated from data entry and reconciling duties?

*2. Do all internal entries other than service charges require the approval of appropriate supervisory personnel?

*3. If not included in the internal or external audit program, are employees’ and officers’ accounts, accounts of employees’ and officers’ business interests, and accounts controlled by employees and officers periodically reviewed for unusual or prohibited activity?

*4. For unidentified deposits:
   a. Are deposit slips kept under dual control?
   b. Is the disposition of deposit slips approved by an appropriate officer?

*5. For returned checks, unposted items, and
other rejects:
a. Are daily listings of such items prepared?
b. Are all items reviewed daily, and is disposition of items required within a reasonable time period? If so, indicate the time period.
c. Are reports prepared for management that show items not disposed of within the established time frames?

6. Are customers immediately notified in writing of deposit errors?

7. Does the bank require a customer’s signature for stop-payment orders?

8. For automatic transfer accounts:
a. Are procedures in effect that require officer approval for transfers in excess of the savings balance?
b. For nonautomated systems, are transfers made by employees who do not also handle cash, execute external funds transfers, issue official checks singly, or post subsidiary records?

9. For telephone transfer accounts:
a. Do depositors receive an individual identification code for use in making transfers?
b. Are transfers made by employees who do not also handle cash, execute external funds transfers, issue official checks singly, or post subsidiary records?

*10. If not included in the internal or external audit program, are accrual balances for the various types of deposits verified periodically by an authorized official? If so, indicate how often.

*11. Are accounts with a “hold-balance” status—those accounts on which court orders have been placed, those pledged as security to customers’ loans, those pending the clearing of a large check, those for which the owner is deceased, and those for which the passbook has been lost—“locked out” for transactions unless the transaction is approved by appropriate management?

12. For passbook accounts:
a. Do all entries to passbooks contain teller identification?
b. Under a window-posting system, are recording media and passbooks posted simultaneously?
c. Are tellers prohibited from holding customers’ savings passbooks?
d. If customers’ passbooks are held, are they maintained under the institution’s “hold-mail” program and kept under dual control?
e. Are customers prohibited from withdrawing funds without a passbook? If not, state the policy.

13. For withdrawals from savings or other time accounts:
a. Are withdrawal tickets canceled daily?
b. Are procedures in place to preclude overdrafts?
c. Are procedures in effect to place holds on, and to check for holds on, withdrawals over a stated amount? If so, indicate the amount.

14. For signature cards on demand and time accounts:
a. Are procedures in effect to guard against the substitution of false signatures? Describe the procedures.
b. Are signature cards stored to preclude physical damage?
c. Are signatures compared for withdrawals and cashed checks? Describe the procedures.

OFFICIAL CHECKS, MONEY ORDERS, AND CERTIFIED CHECKS

*1. Are separate general-ledger accounts maintained for each type of official check?

*2. For each type of check issued:
a. Are multicopy checks and certified-check forms used? If not, are detailed registers of disbursed checks maintained?
b. Are all checks prenumbered and issued in sequence?
c. Is check preparation and issuance separate from recordkeeping?
d. Is the signing of checks in advance prohibited?
e. Do procedures prohibit the issuance of a check before the credit is processed?

*3. Is the list authorizing bank personnel to sign official checks kept current? Does the list include changes in authorization limits, delete employees who no longer work at the bank, and indicate employees added to the list?

*4. Are appropriate controls in effect over check-signing machines (if used) and certification stamps?
*5. Are voided checks and voided certified-check forms promptly defaced and filed with paid checks?

*6. If reconciliations are not part of the overall deposit-reconciliation function—
   a. are outstanding checks listed and reconciled regularly to the general ledger?
      If so, state how often.
   b. is permanent evidence of reconciliations maintained?
   c. is there clear separation between the preparation of checks, data entry, and check reconciliation?
   d. are the reconciliations reviewed regularly by an authorized officer?
   e. are reconcilement duties rotated on a formal basis in institutions where size precludes the full separation of duties between data entry and reconcilement?
   f. are authorized signatures and endorsements checked by the filing clerk?

*7. For supplies of official checks:
   a. Are records of unissued official checks maintained centrally and at each location storing them?
   b. Are periodic inventories of unissued checks independently performed?
   c. Do the inventories include a description of all checks issued out of sequence?
   d. If users are assigned a supply, is that supply replenished on a consignment basis?

*8. Are procedures in effect to preclude certification of checks drawn against uncollected funds?

**AUDIT**

*1. Are deposit-account activities audited on a sufficiently frequent basis?

*2. Does the scope of the audit program require, and do audit records support, substantive testing or quantitative measurements of deposit-account activities that, at a minimum, include the matters set forth in this questionnaire?

*3. Does the audit program include a comprehensive confirmation program with the customers of each deposit category maintained by the institution?

*4. Do audit department records support the execution of the confirmation program, and do the records reflect satisfactory follow-up of responses and of requests returned as undeliverable?

*5. Are audit and prior-examination recommendations for deposit-account activities appropriately addressed?

**CONCLUSION**

*1. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

*2. Are internal controls adequate on the basis of a composite evaluation, as evidenced by answers to the foregoing questions?
Borrowed Funds
Effective date October 2008

Common Sources of Borrowings

Federal Home Loan Bank Borrowings

The Federal Home Loan Bank (FHLB) originally served solely as a source of borrowings to savings and loan companies. With the implementation of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), FHLB’s lending capacity was expanded to include banks.

Compared with borrowings from the discount window of the Reserve Banks, borrowings from the FHLB have fewer conditions. Both short-term and long-term borrowings, with maturities ranging from overnight to 30 years, are available to institutions at generally competitive interest rates. The flexibility of the facility enables bank management to use this source of funds for the purpose of asset/liability management, and it allows management to secure a favorable interest-rate spread. For example, FHLB borrowings may provide a lower-cost alternative to the conventional deposit, particularly in a highly competitive local market.

Management should be capable of explaining the purpose of the borrowing transaction. The borrowing transaction should then be analyzed to determine whether the arrangement achieved the stated purpose or whether the borrowings are a sign of liquidity deficiencies. Further, the borrowing agreement between the institution and the FHLB should be reviewed to determine the asset collateralizing the borrowings and the potential risks presented by the agreement. In some instances, the borrowing agreement may provide for collateralization by all assets not already pledged for other purposes.

The types of collateral necessary to obtain an FHLB loan include residential mortgage loans and mortgage-backed securities. The composite rating of an institution is a factor in both the approval for obtaining an FHLB loan and the level of collateral required.
Federal Funds Purchased

The day-to-day use of federal funds is a rather common occurrence, and federal funds are considered an important money market instrument. Many regional and money-center banks, acting in the capacity of correspondents to smaller community banks, function as both providers and purchasers of federal funds and, in the process of these transactions, often generate a small return.

A brief review of bank reserves is essential to a discussion of the federal funds market. As a condition of membership in the Federal Reserve System, member banks are required to maintain a portion of their deposits as reserves. Reserves can take the form of vault cash and deposits in the Reserve Bank. The amount of these reserve balances is reported weekly or quarterly and computed on the basis of the daily average deposit balances. For institutions that report their reserves on a weekly basis, required reserves are computed on the basis of daily average balances of deposits and Eurocurrency liabilities during a 14-day period ending every second Monday. Institutions that report their reserves on a quarterly basis compute their reserve requirement on the basis of their daily average deposit balances during a seven-day computation period that begins on the third Tuesday of March, June, September, and December. (See 12 CFR 204.3(c)–(d).)

Since member banks do not receive interest on the reserves, banks prefer to keep excess balances at a minimum to achieve the maximum utilization of funds. To accomplish this goal, banks carefully analyze and forecast their daily reserve position. Changes in the volume of required reserves occur frequently as the result of deposit fluctuations. Deposit increases require member banks to maintain more reserves; conversely, deposit decreases require less reserves.

The most frequent type of federal funds transaction is unsecured for one day and repayable the following business day. The rate is usually determined by overall money market rates as well as by the available supply of and demand for funds. In some instances, when the selling and buying relationship between two banks is quite continuous, something similar to a line of credit may be established on a funds-availability basis. Although the most common federal funds transaction is unsecured, the selling of funds can also be secured and for longer periods of time. Agency-based federal funds transactions are discussed in “Bank Dealer Activities,” section 2030.1.

Loans from Correspondent Banks

Small and medium-sized banks often negotiate loans from their principal correspondent banks. The loans are usually for short periods and may be secured or unsecured.

Repurchase Agreements

The terms “repurchase agreement” and “reverse repurchase agreement” refer to a type of transaction in which a money market participant acquires immediately available funds by selling securities and simultaneously agreeing to repurchase the securities after a specified time at a given price, which typically includes interest at an agreed-on rate. Such a transaction is called a repo when viewed from the perspective of the supplier of the securities (the borrower), and a reverse repo or matched sale-purchase agreement when described from the point of view of the supplier of funds (the lender).

Frequently, instead of resorting to direct borrowings, a bank may sell assets to another bank or some other party and simultaneously agree to repurchase the assets at a specified time or after certain conditions have been met. Bank securities as well as loans are often sold under a repo to generate temporary working funds. These kind of agreements are often used because the rate on this type of borrowing is less than the rate on unsecured borrowings, such as federal funds purchased.

The usual terms for the sale of securities under a repo require that, after a stated period of time, the seller repurchase the securities at a predetermined price or yield. A repo commonly includes a near-term maturity (overnight or a few days) and is usually arranged in large-dollar amounts. The lender or buyer is entitled to receive compensation for use of the funds provided to its counterparty. The interest rate paid on a repo is negotiated based on the rates on the underlying securities. U.S. government and agency securities are the most common type of

instruments sold under repurchase agreements, since those types of repos are exempt from reserve requirements.

Although standard overnight and term repo arrangements in Treasury and federally related agency securities are most prevalent, market participants sometimes alter various contract provisions to accommodate specific investment needs or to provide flexibility in the designation of collateral. For example, some repo contracts allow substitutions of the securities subject to the repurchase commitment. These are called “dollar repurchase agreements” (dollar rolls), and the initial seller’s obligation is to repurchase securities that are substantially similar, but not identical, to the securities originally sold. Another common repo arrangement is called a “flex repo,” which, as implied by the name, provides a flexible term to maturity. A flex repo is a term agreement between a dealer and a major customer in which the customer buys securities from the dealer and may sell some of them back before the final maturity date.

Bank management should be aware of certain considerations and potential risks of repurchase agreements, especially when entering into large-dollar-volume transactions with institutional investors or brokers. Both parties in a term repo arrangement are exposed to interest-rate risk. It is a fairly common practice to have the collateral value of the underlying securities adjusted daily to reflect changes in market prices and to maintain the agreed-on margin. Accordingly, if the market value of the repo securities declines appreciably, the borrower may be asked to provide additional collateral. Conversely, if the market value of the securities rises substantially, the lender may be required to return the excess collateral to the borrower. If the value of the underlying securities exceeds the price at which the repurchase agreement was sold, the bank could be exposed to the risk of loss if the buyer is unable to perform and return the securities. This risk would obviously increase if the securities are physically transferred to the institution or broker with which the bank has entered into the repurchase agreement. Moreover, if the securities are not returned, the bank could be exposed to the possibility of a significant write-off, to the extent that the book value of the securities exceeds the price at which the securities were originally sold under the repurchase agreement. For this reason, banks should avoid pledging excessive collateral and obtain sufficient financial information on and analyze the financial condition of those institutions and brokers with whom they engage in repurchase transactions.

“Retail repurchase agreements” (retail repos) for a time were a popular vehicle for some commercial banks to raise short-term funds and compete with certain instruments offered by nonbanking competitors. For booking purposes, a retail repo is a debt incurred by the issuing bank that is collateralized by an interest in a security that is either a direct obligation of or guaranteed as to principal and interest by the U.S. government or an agency thereof. Retail repos are issued in amounts not exceeding $100,000 for periods of less than 90 days. With the advent of money market certificates issued by commercial banks, the popularity of the retail repo declined.

Both retail and large-denomination, wholesale repurchase agreements are in many respects equivalent to short-term borrowings at market rates of interest. Therefore, banks engaging in repurchase agreements should carefully evaluate their interest-rate-risk exposure at various maturity levels, formulate policy objectives in light of the institution’s entire asset and liability mix, and adopt procedures to control mismatches between assets and liabilities. The degree to which a bank borrows through repurchase agreements also should be analyzed with respect to its liquidity needs, and contingency plans should provide for alternative sources of funds.

**Negotiable Certificates of Deposit**

Certificates of deposit (CDs) have not been legally defined as borrowings and continue to be reflected as deposits for reporting purposes. However, the fundamental distinction between a negotiable money market CD as a deposit or as a borrowing is nebulous at best; in fact, the negotiable money market CD is widely recognized as the primary borrowing vehicle for many banks. Dependence on CDs as sources of funds is discussed in “Deposit Accounts,” section 3000.1.

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Borrowings from the Federal Reserve

In accordance with the Board’s Regulation A (12 CFR 201), the Federal Reserve Banks generally make credit available through the primary, secondary, and seasonal credit programs. The credit is available as a backup source of funding other than a routine one. An institution that borrows primary credit may use those funds to finance sales of federal funds, but secondary and seasonal credit borrowers may not act as the medium or agent of another depository institution in receiving Federal Reserve credit except with the permission of the lending Federal Reserve Bank.

A Federal Reserve Bank is not obligated to extend credit to any depository institution but may lend to a depository institution either by making an advance secured by acceptable collateral or by discounting certain types of paper described in the Federal Reserve Act. Although Reserve Banks now always extend credit in the form of an advance, the Federal Reserve’s credit facility nonetheless is known colloquially as the “discount window.” Before lending to a depository institution, a Reserve Bank can require any information it believes is appropriate to ensure that the assets tendered as collateral are acceptable. A Reserve Bank also should determine prior to lending whether the borrowing institution is undercapitalized or critically undercapitalized. Operating Circular No. 10, “Lending,” establishes the credit and security terms for borrowings from the Federal Reserve.

3. In unusual and exigent circumstances and after consultation with the Board, a Reserve Bank may extend credit to individuals, partnerships, and corporations that are not depository institutions if, in the judgment of the Reserve Bank, credit is not available from other sources and failure to obtain credit would adversely affect the economy. A Reserve Bank may extend credit to a nondepository entity in the form of an advance only if the advance is secured by a direct obligation of the United States or a direct obligation of, or an obligation that is fully guaranteed as to principal and interest by, any agency of the United States. An extension of credit secured by any other type of collateral must be in the form of a discount and must be authorized by an affirmative vote of at least five members of the Board.

Primary Credit

Reserve Banks may extend primary credit on a very short term basis (typically overnight) to depository institutions that the Reserve Banks judge to be in generally sound financial condition. Reserve Banks extend primary credit at a rate above the target federal funds rate of the Federal Open Market Committee. Minimal administrative requirements apply to requests for overnight primary credit, unless some aspect of the credit request appears inconsistent with the conditions of primary credit (for example, if a pattern of behavior indicates strongly that an institution is using primary credit other than as a backup source of funding). Reserve Banks also may extend primary credit to eligible institutions for periods of up to several weeks if such funding is not available from other sources. However, longer-term extensions of primary credit will be subject to greater administration than are overnight loans.

Reserve Banks determine eligibility for primary credit according to a uniform set of criteria that also is used to determine eligibility for daylight credit under the Board’s Policy Statement on Payments System Risk. These criteria are based mainly on examination ratings and capitalization, although Reserve Banks also may use supplementary information, including market-based information when available. Specifically, an institution that is at least adequately capitalized and rated CAMELS 1 or 2 (or SOSA 1 and ROCA 1, 2, or 3) almost certainly would be eligible for primary credit. An institution that is at least adequately capitalized and rated CAMELS 3 (or SOSA 2 and ROCA 1, 2, or 3) generally would be eligible. An institution that is at least adequately capitalized and rated CAMELS 4 (or SOSA 1 or 2 and ROCA 4 or 5) would be eligible only if an ongoing examination indicated a substantial improvement in condition. An institution that is not at least adequately capitalized, or that is rated CAMELS 5 (or SOSA 3 regardless of the ROCA rating), would not be eligible for primary credit.

Secondary Credit

Secondary credit is available to institutions that do not qualify for primary credit. Secondary credit is available as a backup source of liquidity on a very short term basis, provided that the loan is consistent with a timely return to a reliance on...
market sources of funds. Longer-term secondary credit is available if necessary for the orderly resolution of a troubled institution, although any such loan would have to comply with additional requirements for lending to undercapitalized and critically undercapitalized institutions. Unlike the primary credit program, secondary credit is not a minimal administration facility because Reserve Banks must obtain sufficient information about a borrower’s financial situation to ensure that an extension of credit complies with the conditions of the program. Secondary credit is available at a rate above the primary credit rate.

**Seasonal Credit**

Seasonal credit is available under limited conditions to meet the needs of depository institutions that have seasonal patterns of movement in deposits and loans but that lack ready access to national money markets. In determining a depository institution’s eligibility for seasonal credit, Reserve Banks consider not only the institution’s historical record of seasonal fluctuations in loans and deposits, but also the institution’s recent and prospective needs for funds and its liquidity conditions. Generally, only very small institutions with pronounced seasonal funding needs will qualify for seasonal credit. Seasonal credit is available at a flexible rate that takes into account the rate for market sources of funds.

**Collateral Requirements**

All loans advanced by the Reserve Bank must be secured to the satisfaction of the Reserve Bank. Collateral requirements are governed by Operating Circular No. 8. Reserve Banks require a perfected security interest in all collateral pledged to secure loans. Satisfactory collateral generally includes U.S. government and federal-agency securities, and, if they are of acceptable quality, mortgage notes covering one- to four-family residences; state and local government securities; and business, consumer, and other customer notes. Traditionally, collateral is held in the Reserve Bank vault. Under certain circumstances, collateral may be retained on the borrower’s premises under a borrower-in-custody arrangement, or it may be held on the borrower’s premises under the Reserve Bank’s exclusive custody and control in a field ware-house arrangement. Collateral may also be held at the borrowing institution’s correspondent or another third party. All book-entry collateral must be held at the Federal Reserve Bank. Definitive collateral, not in bearer form, must be properly assigned and endorsed.

**Lending to Undercapitalized and Critically Undercapitalized Depository Institutions**

Credit from any Reserve Bank to an institution that is “undercapitalized” may be extended or outstanding for no more than 60 days during which the institution is undercapitalized in any 120-day period. An institution is considered undercapitalized if it is not critically undercapitalized under section 38 of the Federal Deposit Insurance Act (the FDI Act) but is either deemed undercapitalized under that provision and its implementing regulations or has received a composite CAMELS rating of 5 as of the most recent examination. A Reserve Bank may make or have outstanding advances or discounts to an institution that is deemed “critically undercapitalized” under section 38 of the FDI Act and its implementing regulations only during the five-day period beginning on the date the institution became critically undercapitalized or after consultation with the Board.

**INTERNATIONAL BORROWINGS**

International borrowings may be direct or indirect. Common forms of direct international borrowings include loans and short-term call money from foreign banks, borrowings from the Export-Import Bank of the United States, and overdrawn nostro (due from foreign banks—demand) accounts. Indirect forms of borrowing include notes and trade bills rediscounted with the central banks of various countries; notes, acceptances, import drafts, or trade bills sold with the bank’s endorsement or guarantee; notes and other obligations sold subject to repurchase agreements; and acceptance pool participations.

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4. Generally, a Reserve Bank also may lend to an undercapitalized institution during 60 calendar days after receipt of a certificate of viability from the Chairman of the Board of Governors or after consultation with the Board.
ANALYZING BORROWINGS

If a bank borrows extensively or in large amounts, the examiner should thoroughly analyze the borrowing activity. An effective analysis includes a review of the bank’s reserve records, both required and maintained, to determine the frequency of deficiencies at the closing of reserve periods. The principal sources of borrowings, range of amounts, frequency, length of time indebted, cost, and reasons for the borrowings should be explored. The actual use of the funds should be verified.

Examiners should also analyze changes in a bank’s borrowing position for signs of deterioration in its borrowing ability and overall creditworthiness. One indication of deterioration is the payment of large fees to money brokers to obtain funds because the bank is having difficulty obtaining access to conventional sources of borrowings. These “brokered deposits” are usually associated with small banks since they do not generally have ready access to alternative sources of funds available to larger institutions through the money and capital markets. Brokered deposits generally carry higher interest rates than alternative sources, and they tend to be particularly susceptible to interest-rate changes in the overall financial market. For further discussion of brokered deposits, see “Deposit Accounts,” section 3000.1.

Other indicators of deterioration in a bank’s borrowing ability and overall creditworthiness include, but are not limited to, requests for collateral on previously unsecured credit lines or increases in collateral margins, the payment of above-market interest rates, or a shortening of maturities that is inconsistent with management’s articulated balance-sheet strategies. If the examiner finds that a bank’s borrowing position is not properly managed, appropriate comments should be included in the report of examination.
1. To determine if the policies, practices, procedures, and internal controls for borrowed funds are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine compliance with laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.
1. If selected for implementation, complete or update the Borrowed Funds section of the Internal Control Questionnaire.

2. Based on the evaluation of internal controls and the work performed by the internal/external auditors, determine the scope of the examination.

3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors from the examiner assigned to “Internal Control” and determine if appropriate corrections have been made.

4. Obtain the listing of accounts related to domestic and international borrowed funds from the examiner assigned to “Examination Strategy.”

5. Prepare or obtain a listing of borrowings, by type, and—
   a. agree or reconcile balances to department controls and general ledger, and
   b. review reconciling items for reasonableness.

6. From consultation with the examiners assigned to the various loan areas, determine that the following schedules were reviewed in the lending departments and that there was no endorsement, guarantee, or repurchase agreement which would constitute a borrowing:
   a. participations sold
   b. loans sold in full since the preceding examination

7. Based on the information obtained in steps 5 and 6, and through observation and discussion with management and other examining personnel, determine that all borrowings are properly reflected on the books of the bank.

8. If the bank engages in any form of borrowing which requires written borrowing agreement(s), complete the following:
   a. Prepare or update a carry-forward workpaper describing the major terms of each borrowing agreement, and determine that the bank is complying with those terms.
   b. Review terms of past and present borrowing agreements for indications of deteriorating credit position by noting—
      • recent substantive changes in borrowing agreements,
      • increases in collateral to support borrowing transactions,
      • general shortening of maturities,
      • interest rates exceeding prevailing market rates,
      • frequent changes in lenders, and
      • large fees paid to money brokers.

   c. If the bank has obtained funds from money brokers (brokered deposits), determine—
      • why such deposits were originally obtained,
      • who the deposits were obtained from,
      • what the funds are used for,
      • the relative cost of brokered deposits in comparison to alternate sources of funds, and
      • the overall effect of the use of brokered deposits on the bank’s condition and whether there appear to be any abuses related to the use of such deposits.

   d. If there is an indication that the bank’s credit position has deteriorated, ascertain why.

9. If the bank engages in the issuance of retail repurchase agreements (retail repos), check for compliance with section 4170.1; also 2015.1 and 2020.1.

10. Determine the purpose of each type of borrowing and conclude whether the bank’s borrowing posture is justified in light of its financial condition and other relevant circumstances.

11. Provide the examiner assigned to “Asset/Liability Management” the following information:
   a. A summary and an evaluation of the bank’s borrowing policies, practices, and procedures. The evaluation should give consideration to whether the bank—
      • evaluates interest-rate-risk exposure at various maturity levels;
      • formulates policy objectives in light of the entire asset and liability mix, and liquidity needs;
      • has adopted procedures to control mis-
matches between assets and liabilities; and

• has contingency plans for alternate sources of funds in the event of a run-off of current funding sources.

b. An evaluation of the bank’s adherence to established policies and procedures.

c. A repricing maturity schedule of borrowings.

d. A listing of prearranged federal funds lines and other lines of credit. Indicate the amount currently available under those lines, i.e., the unused portion of the lines.

e. The amount of any anticipated decline in borrowings over the next day period. (The time period will be determined by the examiner assigned to “Asset/Liability Management.”)

12. Prepare a list of all borrowings by category, on a daily basis for the period since the last examination. Also, include on the list short-term or overnight money market lending activities such as federal funds sold and securities purchased under resale agreement. For each category on the list, compute for the period between examinations—

a. high point

b. low point

c. average amounts outstanding

d. frequency of borrowing and lending activity, expressed in terms of number of days

13. Prepare, in appropriate report form, and discuss with appropriate management—

a. the adequacy of written policies regarding borrowings;

b. the manner in which bank officers are operating in conformance with established policy;

c. the existence of any unjustified borrowing practices;

d. any violation of laws or regulations; and

e. recommended corrective action when policies, practices, or procedures are deficient; violations of laws or regulations exist; or when unjustified borrowing practices are being pursued.

14. Update the workpapers with any information that will facilitate future examinations.

15. Review the market value of collateral and collateral-control arrangements for repurchase agreements to ensure that excessive collateral has not been pledged and that the bank is not exposed to excessive credit risks.
Borrowed Funds
Internal Control Questionnaire
Effective date March 1984

Review the bank’s controls, policies, practices and procedures for obtaining and servicing borrowed funds. The bank’s system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

**POLICY**

1. Has the board of directors approved a written policy which:
   a. Outlines the objectives of bank borrowings?
   b. Describes the bank’s borrowing philosophy relative to risk considerations, i.e., leverage/growth, liquidity/income?
   c. Provides for risk diversification in terms of staggered maturities rather than solely on cost?
   d. Limits borrowings by amount outstanding, specific type or total interest expense?
   e. Limits or restricts execution of borrowings by bank officers?
   f. Provides a system of reporting requirements to monitor borrowing activity?
   g. Requires subsequent approval of transactions?
   h. Provides for review and revision of established policy at least annually?

**RECORDS**

*2. Does the bank maintain subsidiary records for each type of borrowing, including proper identification of the obligee?

**INTEREST**

*4. Are subsidiary borrowed funds records reconciled with the general ledger accounts at an interval consistent with borrowing activity, and are the reconciling items investigated by persons, who do not also:
   a. Handle cash?
   b. Prepare or post to the subsidiary borrowed funds records?

*5. Are individual interest computations checked by persons who do not have access to cash?

6. Is an overall test of the total interest paid made by persons who do not have access to cash?

7. Are payees on the checks matched to related records of debt, note or debenture owners?

8. Are corporate resolutions properly prepared as required by creditors and are copies on file for reviewing personnel?

9. Are monthly reports furnished to the board of directors reflecting the activity of borrowed funds, including amounts outstanding, interest rates, interest paid to date and anticipated future activity?

**CONCLUSION**

10. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

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

Commercial banks rely on wholesale borrowings obtained from a number of financial intermediaries, including Federal Home Loan Banks, other commercial banks, and securities firms. These borrowings frequently have attractive features and pricing. If properly assessed and prudently managed, they can enhance a bank’s funding options and assist in controlling interest-rate and liquidity risks. Some of the reasons that banks use these types of borrowings include the initial low cost of funds when compared with other liabilities with similar maturities. At the same time, certain wholesale borrowings have become more complex, and some structures include various types of embedded options. If not thoroughly assessed and prudently managed, these more complex funding instruments have the potential over time to significantly increase a bank’s sensitivity to market and liquidity risks. Maturity mismatches or the embedded options themselves can, in some circumstances, adversely affect a bank’s financial condition, especially when the terms and conditions of the borrowings are misunderstood.

A growing use of wholesale borrowings, combined with the risks associated with the complex structures of some of these borrowings, makes it increasingly important for bank supervisors to assess the risks and risk-management processes associated with these sources of funds. The supervisory guidance provided below supplements and expands upon existing general guidance on bank funding and borrowings. Where appropriate, examiners should (1) review the provisions of each significant borrowing agreement between the bank and the wholesale institution, (2) determine what assets collateralize the borrowing (or borrowings), and (3) identify the potential risks presented by the agreement. (See SR-01-8.)

In addition to determining if a bank follows the sound-practice guidance for bank liability management and funding in general, supervisors should take the following steps, as appropriate, when assessing a bank that has material amounts of wholesale borrowings:

- Review the bank’s borrowing contracts for embedded options or other features that may affect the bank’s liquidity and sensitivity to market risks. In addition, examiners should review the collateral agreements for fees, collateral-maintenance requirements (including triggers for increases in collateral), and other features that may affect the bank’s liquidity and earnings.
- Assess the bank’s management processes for identifying and monitoring the risks of the various terms of each borrowing contract, including penalties and option features over the expected life of the contract. Examiners should review for evidence that the bank’s management, or an independent third party, completed stress tests (1) before the bank entered into the borrowing agreement (or agreements) and (2) periodically thereafter. If the bank relies on independent third-party testing, examiners should verify that management and funding reviewed and accepted the underlying assumptions and test results. In any case, management should not be relying solely on the wholesaler’s stress-test results. Also, the stress tests employed should cover a reasonable range of contractual triggers and external events. Such triggers or events include interest-rate changes that may result in the exercise of embedded options or the bank’s termination of the agreement, which may entail prepayment penalties. In general, stress-test results should depict the potential impact of these variables on the individual borrowing facility, as well as on the overall earnings and liquidity position of the bank.
- Evaluate management processes for controlling risks, including interest-rate risks arising from the borrowings and liquidity risks. Proper controls include (1) hedges or other plans for minimizing the adverse effects of penalties or interest-rate changes and other triggers for embedded options and (2) contingent funding strategies.

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1. Wholesale borrowings with embedded options may have variable interest payments or average lives or redemption values that depend on external measures such as reference rates, indexes, or formulas. Embedded options include putable, callable, convertible, and variable rate advances with caps, floors, collars, step-ups, or amortizing features. In addition, these types of borrowings may contain prepayment penalties.

2. See the supervisory guidance for “Borrowed Funds,” section 3010.1; “Asset/Liability Management,” section 4020.1; and “Interest-Rate Risk Management,” section 4090.1. See also the Trading and Capital-Markets Activities Manual, sections 2030.1, “Liquidity Risk,” and 3010.1, “Interest-Rate Risk Management.” In general, this guidance collectively calls for supervisors to analyze the purpose, effectiveness, concentration exposure, and stability of borrowings and to assess bank management’s understanding of liquidity and interest-rate risks associated with borrowing and funding strategies.
plans if borrowings or lines are terminated before the original expected maturity.

- Determine whether the asset/liability management committee or board of directors, as appropriate, is fully informed of the risks and ramifications of complex wholesale-borrowing agreements before engaging in the transactions and on an ongoing basis.

- Determine whether funding strategies for wholesale borrowings, especially those with embedded options, are consistent with both the portfolio objectives of the bank and the level of sophistication of the bank’s risk management. Banks without the technical knowledge and whose risk-management systems are insufficient to adequately identify, assess, monitor, and control the risks of complex wholesale borrowings should not be using this funding.

Reliance on wholesale borrowings is consistent with safe and sound banking when management understands the risks of these activities and has systems and procedures in place to properly monitor and control the risks. Supervisors and examiners, however, should take appropriate steps to follow up on institutions that use complex funding instruments without adequately understanding their risks or without proper risk-management systems and controls. Examiners should also seek corrective action when funding mechanisms or strategies are inconsistent with prudent funding needs and objectives.
Complex Wholesale Borrowings
Examination Objectives
Effective date May 2001

1. To review the terms of wholesale-borrowing contracts to identify embedded options or other features that may affect the bank’s liquidity and sensitivity to market risks.

2. To assess management’s technical knowledge, systems, and processes for identifying, assessing, monitoring, and controlling the risks (including liquidity risk and interest-rate risk) associated with wholesale borrowing, and to assess the bank’s stress-testing practices and contingency-funding plans.

3. To determine if the bank’s board of directors or its asset/liability management committee is fully aware of the risks associated with and ramifications of engaging in complex wholesale-borrowing agreements.

4. To ascertain whether the bank’s wholesale-borrowing funding and hedging strategies are consistent with its portfolio objectives and the level of management’s sophistication.
Complex Wholesale Borrowings
Examination Procedures
Effective date May 2001

Section 3012.3

1. Review the bank’s borrowing contracts to identify embedded options or other features that may affect the bank’s liquidity and sensitivity to market risks. Also review the collateral agreements to determine what fees, collateral-maintenance requirements (including triggers for increases in collateral), and other agreed-upon features may affect the bank’s liquidity and earnings.

2. Assess the bank’s management processes for identifying and monitoring the risks of the various terms of each borrowing contract, including penalties and option features over the expected life of the contract.
   a. Obtain and examine evidence to determine whether the bank’s management, or an independent third party, completed stress tests before the bank entered into the borrowing agreement (or agreements) and periodically thereafter.
   b. If the bank relies on independent third-party testing, verify that management reviewed and accepted the underlying assumptions and test results.

3. Evaluate the management processes for controlling risks, including (1) interest-rate risks arising from the borrowings and (2) liquidity risks.

4. Determine if the asset/liability management committee or board of directors, as appropriate, is fully informed of the risks and ramifications of complex wholesale-borrowing agreements both before engaging in the transactions and on an ongoing basis.

5. Determine if funding strategies for wholesale borrowings, especially those with embedded options, are consistent with both the portfolio objectives of the bank and the level of sophistication of the bank’s risk management.

6. Seek the corrective action taken by the institution when funding mechanisms or strategies are inconsistent with prudent funding needs and objectives.
As part of their executive compensation and retention programs, banks and other financial institutions (collectively referred to in this section as “institutions”) often enter into deferred compensation agreements with selected employees. These agreements are generally structured as nonqualified retirement plans for federal income tax purposes and are based on individual agreements with selected employees.

Institutions often purchase bank-owned life insurance (BOLI) in connection with many of their deferred compensation agreements. (See sections 4042.1 and 2210.1 for an explanation of the accounting for BOLI transactions). BOLI may produce attractive tax-equivalent yields that offset some or all of the costs of the agreements.

Deferred compensation agreements are commonly referred to as indexed retirement plans (IRPs) or as revenue-neutral plans. The institution’s designated management and accounting staff that is responsible for the institution’s financial reporting must regularly review the accounting for deferred compensation agreements to ensure that the obligations under the agreements are appropriately measured and reported in accordance with generally accepted accounting principles (GAAP). In so doing, the management and accounting staff should apply and follow Accounting Principles Board Opinion No. 12, “Omnibus Opinion—1967,” as amended by Statement of Financial Accounting Standards No. 106 (FAS 106), “Employers’ Accounting for Postretirement Benefits Other Than Pensions” (hereafter referred to as APB 12).

IRPs are one type of deferred compensation agreement that institutions enter into with selected employees. IRPs are typically designed so that the spread each year, if any, between the tax-equivalent earnings on the BOLI covering an individual employee and a hypothetical earnings calculation is deferred and paid to the employee as a post-retirement benefit. This spread is commonly referred to as excess earnings. The hypothetical earnings are computed on the basis of a predefined variable index rate (for example, the cost of funds or the federal funds rate) times a notional amount. The notional amount is typically the amount the institution initially invested to purchase the BOLI plus subsequent after-tax benefit payments actually made to the employee. By including the after-tax benefit payments and the amount initially invested to purchase the BOLI in the notional amount, the hypothetical earnings reflect an estimate of what the institution could have earned if it had not invested in the BOLI or entered into the IRP with the employee. Each employee’s IRP may have a different notional amount on which the index is based. The individual IRP agreements also specify the retirement age and vesting provisions, which can vary from employee to employee.

An IRP agreement typically requires the excess earnings that accrue before an employee’s retirement to be recorded in a separate liability account. Once the employee retires, the balance in the liability account is generally paid to the employee in equal, annual installments over a set number of years (for example, 10 or 15 years). These payments are commonly referred to as the primary benefit or pre-retirement benefit.

An employee may also receive the excess earnings that are earned after his or her retirement. This benefit may continue until the employee’s death and is commonly referred to as the secondary benefit or post-retirement benefit. The secondary benefit is paid annually, once the employee has retired, and is in addition to the primary benefit.

Examiners should be aware that some institutions may not be correctly accounting for the obligations under an IRP. Because many institutions were incorrectly accounting for IRPs, the federal banking and thrift agencies issued on February 11, 2004, an Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance. (See SR-04-4.) The guidance is stated here, except for the information on the reporting of deferred compensation agreement obligations in the bank Call Reports and on changes in accounting for those agreements. Examiners should determine whether an institution’s deferred compensation agreements are correctly accounted for. If the accounting is incorrect, assurance should be obtained from the institution’s management that corrections will be made in accordance with GAAP and the advisory’s instructions for changes in accounting. The examiner’s findings should be reported in the examination report. Also report the nature of the accounting errors and the estimated financial impact that correcting the errors will have on the institution’s
Deferred Compensation Agreements

ACCOUNTING FOR DEFERRED COMPENSATION AGREEMENTS, INCLUDING IRPs

Deferred compensation agreements with select employees under individual contracts generally do not constitute post-retirement income plans (that is, pension plans) or post-retirement health and welfare benefit plans. The accounting for individual contracts that, when taken together, do not represent a post-retirement plan should follow APB 12. If the individual contracts, taken together, are equivalent to a plan, the plan should be accounted for under Statement of Financial Accounting Standards No. 87, “Employers’ Accounting for Pensions,” or under FAS 106.

APB 12 requires that an employer’s obligation under a deferred compensation agreement be accrued according to the terms of the individual contract over the required service period to the date the employee is fully eligible to receive the benefits, or the full eligibility date. Depending on the individual contract, the full eligibility date may be the employee’s expected retirement date, the date the employee entered into the contract, or a date between these two dates. APB 12 does not prescribe a specific accrual method for the benefits under deferred compensation contracts, stating only that the “cost of those benefits shall be accrued over that period of the employee’s service in a systematic and rational manner.” The amounts to be accrued each period should result in a deferred compensation liability at the full eligibility date that equals the then-present value of the estimated benefit payments to be made under the individual contract.

APB 12 does not specify how to select the discount rate to measure the present value of the estimated benefit payments. Therefore, other relevant accounting literature must be considered in determining an appropriate discount rate. An institution’s incremental borrowing rate and the current rate of return on high-quality fixed-income debt securities should be the acceptable discount rates to measure deferred compensation agreement obligations. An institution must select and consistently apply a discount-rate policy that conforms with GAAP.

For each IRP, an institution should calculate the present value of the expected future benefit payments under the IRP at the employee’s full eligibility date. The expected future benefit payments can be reasonably estimated. They should be based on reasonable and supportable assumptions and should include both the primary benefit and, if the employee is entitled to excess earnings that are earned after retirement, the secondary benefit. The estimated amount of these benefit payments should be discounted because the benefits will be paid in periodic installments after the employee retires. The number of periods the primary and any secondary benefit payments should be discounted may differ because the discount period for each type of benefit payment should be based on the length of time during which each type of benefit will be paid, as specified in the IRP.

After the present value of the expected future benefit payments has been determined, the institution should accrue an amount of compensation expense and a liability each year from the date the employee enters into the IRP until the full eligibility date. The amount of these annual accruals should be sufficient to ensure that a deferred compensation liability equal to the present value of the expected benefit payments is recorded by the full eligibility date. Any method of deferred compensation accounting that does not recognize some expense for the primary benefit and any secondary benefit in each year from the date the employee enters into the IRP until the full eligibility date is not considered to be systematic and rational.

Vesting provisions should be reviewed to ensure that the full eligibility date is properly determined because this date is critical to the measurement of the liability estimate. Because APB 12 requires that the present value of the expected benefit payments be recorded by the full eligibility date, institutions also need to consider changes in market interest rates to appropriately measure deferred compensation.

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1. Accounting Principles Board Opinion No. 21, “Interest on Receivables and Payables,” paragraph 13, states in part that “the rate used for valuation purposes will normally be at least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction.”

2. FAS 106, paragraph 186, states that “[t]he objective of selecting assumed discount rates is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the accumulated benefits when due.”
liabilities. Therefore, to comply with APB 12, institutions should periodically review both their estimates of the expected future benefits under IRPs and the discount rates used to compute the present value of the expected benefit payments, and revise those estimates and rates, when appropriate.

Deferred compensation agreements, including IRPs, may include noncompete provisions or provisions requiring employees to perform consulting services during post-retirement years. If the value of the noncompete provisions cannot be reasonably and reliably estimated, no value should be assigned to the noncompete provisions in recognizing the deferred compensation liability. Institutions should allocate a portion of the future benefit payments to consulting services to be performed in post-retirement years only if the consulting services are determined to be substantive. Factors to consider in determining whether post-retirement consulting services are substantive include but are not limited to (1) whether the services are required to be performed, (2) whether there is an economic benefit to the institution, and (3) whether the employee forfeits the benefits under the agreement for failure to perform such services.

APPENDIX—EXAMPLES OF ACCOUNTING FOR DEFERRED COMPENSATION AGREEMENTS

The following are examples of the full-eligibility-date accounting requirements for a basic deferred compensation agreement. The assumptions used in these examples are for illustrative purposes only. An institution must consider the terms of its specific agreements, the current interest-rate environment, and current mortality tables in determining appropriate assumptions to use in measuring and recognizing the present value of the benefits payable under its deferred compensation agreements.

Institutions that enter into deferred compensation agreements with employees, particularly more-complex agreements (such as IRPs), should consult with their external auditors and their respective Federal Reserve Bank to determine the appropriate accounting for their specific agreements.

Example 1: Fully Eligible at Agreement Inception

A company enters into a deferred compensation agreement with a 55-year-old employee who has worked five years for the company. The agreement states that, in exchange for the employee’s past and future services and for his or her service as a consultant for two years after retirement, the company will pay an annual benefit of $20,000 to the employee, commencing on the first anniversary of the employee’s retirement. The employee is fully eligible for the deferred compensation benefit payments at the inception of the agreement, and the consulting services are not substantive.

Other key facts and assumptions used in determining the benefits payable under the agreement and in determining the liability and expense the company should record in each period are summarized in the following table:

<table>
<thead>
<tr>
<th>Description</th>
<th>Example Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected retirement age</td>
<td>60</td>
</tr>
<tr>
<td>Number of years to expected retirement age</td>
<td>5</td>
</tr>
<tr>
<td>Discount rate (%)</td>
<td>6.75</td>
</tr>
<tr>
<td>Expected mortality age based on present age</td>
<td>70</td>
</tr>
</tbody>
</table>

At the employee’s expected retirement date, the present value of a lifetime annuity of $20,000 that begins on that date is $142,109 (computed as $20,000 times 7.10545, the factor for the present value of 10 annual payments at 6.75 percent). At the inception date of the agreement, the present value of that annuity of $102,514 (computed as $142,109 times 0.721375, the factor for the present value of a single payment in five years at 6.75 percent) is recognized as compensation expense because the employee is fully eligible for the deferred compensation benefit at that date.

The following table summarizes one systematic and rational method of recognizing the expense and liability under the deferred compensation agreement:
### Deferred Compensation Agreements

<table>
<thead>
<tr>
<th>Year</th>
<th>Benefit payment ($)</th>
<th>Service component ($)</th>
<th>Interest component ($)</th>
<th>Compensation expense ($)</th>
<th>Beginning-of-year liability ($)</th>
<th>End-of-year liability ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>–</td>
<td>102,514</td>
<td>–</td>
<td>102,514</td>
<td>–</td>
<td>102,514</td>
</tr>
<tr>
<td>1</td>
<td>–</td>
<td>–</td>
<td>6,920</td>
<td>6,920</td>
<td>102,514</td>
<td>109,434</td>
</tr>
<tr>
<td>2</td>
<td>–</td>
<td>–</td>
<td>7,387</td>
<td>7,387</td>
<td>109,434</td>
<td>116,821</td>
</tr>
<tr>
<td>3</td>
<td>–</td>
<td>–</td>
<td>7,885</td>
<td>7,885</td>
<td>116,821</td>
<td>124,706</td>
</tr>
<tr>
<td>4</td>
<td>–</td>
<td>–</td>
<td>8,418</td>
<td>8,418</td>
<td>124,706</td>
<td>133,124</td>
</tr>
<tr>
<td>5</td>
<td>–</td>
<td>–</td>
<td>8,985</td>
<td>8,985</td>
<td>133,124</td>
<td>142,109</td>
</tr>
<tr>
<td>6</td>
<td>20,000</td>
<td>–</td>
<td>9,593</td>
<td>9,593</td>
<td>142,109</td>
<td>131,702</td>
</tr>
<tr>
<td>7</td>
<td>20,000</td>
<td>–</td>
<td>8,890</td>
<td>8,890</td>
<td>131,702</td>
<td>120,592</td>
</tr>
<tr>
<td>8</td>
<td>20,000</td>
<td>–</td>
<td>8,140</td>
<td>8,140</td>
<td>120,592</td>
<td>108,732</td>
</tr>
<tr>
<td>9</td>
<td>20,000</td>
<td>–</td>
<td>7,339</td>
<td>7,339</td>
<td>108,732</td>
<td>96,071</td>
</tr>
<tr>
<td>10</td>
<td>20,000</td>
<td>–</td>
<td>6,485</td>
<td>6,485</td>
<td>96,071</td>
<td>82,556</td>
</tr>
<tr>
<td>11</td>
<td>20,000</td>
<td>–</td>
<td>5,572</td>
<td>5,572</td>
<td>82,556</td>
<td>68,128</td>
</tr>
<tr>
<td>12</td>
<td>20,000</td>
<td>–</td>
<td>4,599</td>
<td>4,599</td>
<td>68,128</td>
<td>52,727</td>
</tr>
<tr>
<td>13</td>
<td>20,000</td>
<td>–</td>
<td>3,559</td>
<td>3,559</td>
<td>52,727</td>
<td>36,286</td>
</tr>
<tr>
<td>14</td>
<td>20,000</td>
<td>–</td>
<td>2,449</td>
<td>2,449</td>
<td>36,286</td>
<td>18,735</td>
</tr>
<tr>
<td>15</td>
<td>20,000</td>
<td>–</td>
<td>1,265</td>
<td>1,265</td>
<td>18,735</td>
<td>0</td>
</tr>
<tr>
<td>Totals</td>
<td>200,000</td>
<td>102,514</td>
<td>97,486</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The following entry would be made at the inception date of the agreement (the final day of year 0) to record the service component of the compensation expense and related deferred compensation agreement liability:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Compensation expense</td>
</tr>
<tr>
<td></td>
<td>$102,514</td>
</tr>
<tr>
<td></td>
<td>Deferred compensation liability</td>
</tr>
<tr>
<td></td>
<td>$102,514</td>
</tr>
</tbody>
</table>

[To record the column B service component]

In each period after the inception date of the agreement, the company would adjust the deferred compensation liability for the interest component and any benefit payment. In addition, the company would reassess the assumptions used in determining the expected future benefits under the agreement and the discount rate used to compute the present value of the expected benefits. Assuming that no changes were necessary to the assumptions used to determine the expected future benefits under the agreement or to the discount rate used to compute the present value of the expected benefits, the following entry would be made in year 1 to record the interest component of the compensation expense:
Deferred Compensation Agreements

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation expense</td>
<td>$6,920</td>
</tr>
<tr>
<td>Deferred compensation liability</td>
<td>$6,920</td>
</tr>
</tbody>
</table>

[To record the column C interest component (computed by multiplying the prior-year column F balance by the discount rate)]

Similar entries (but for different amounts) would be made in year 2 through year 15 to record the interest component of the compensation expense. The following entry would be made in year 6 to record the payment of the annual benefit:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred compensation liability</td>
<td>$20,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

[To record the column A benefit payment]

Similar entries would be made in year 7 through year 15 to record the payment of the annual benefit.

**Example 2: Fully Eligible at Retirement Date**

If the terms of the contract described in example 1 had stated that the employee is only entitled to receive the deferred compensation benefit if the sum of the employee’s age and years of service equals 70 or more at the date of retirement, the employee would be fully eligible for the deferred compensation benefit at age 60, after rendering five more years of service. At the employee’s expected retirement date, the present value of a lifetime annuity of $20,000 that begins on the first anniversary of that date is $142,109 (computed as $20,000 times 7.10545, the factor for the present value of 10 annual payments at 6.75 percent). The company would accrue this amount in a systematic and rational manner over the five-year period from the date it entered into the agreement to the date the employee is fully eligible for the deferred compensation benefit. Under one systematic and rational method, the annual service component accrual would be $24,835 (computed as $142,109 divided by 5.72213, the factor for the future value of five annual payments at 6.75 percent).

Other key facts and assumptions used in determining the benefits payable under the agreement and in determining the liability and expense the company should record in each period are summarized in the following table:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected retirement age</td>
<td>60</td>
</tr>
<tr>
<td>Number of years to expected retirement age</td>
<td>5</td>
</tr>
<tr>
<td>Discount rate (%)</td>
<td>6.75</td>
</tr>
<tr>
<td>Expected mortality age based on present age</td>
<td>70</td>
</tr>
</tbody>
</table>

The following table summarizes one systematic and rational method of recognizing the expense and liability under the deferred compensation agreement:

---

*Commercial Bank Examination Manual*  
May 2005  
Page 5
<table>
<thead>
<tr>
<th>Year</th>
<th>Benefit payment ($)</th>
<th>Service component ($)</th>
<th>Interest component ($)</th>
<th>Compensation expense ($)</th>
<th>Beginning-of-year liability ($)</th>
<th>End-of-year liability ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>–</td>
<td>24,835</td>
<td>–</td>
<td>24,835</td>
<td>–</td>
<td>24,835</td>
</tr>
<tr>
<td>2</td>
<td>–</td>
<td>24,835</td>
<td>1,676</td>
<td>26,511</td>
<td>24,835</td>
<td>51,346</td>
</tr>
<tr>
<td>3</td>
<td>–</td>
<td>24,835</td>
<td>3,466</td>
<td>28,301</td>
<td>51,346</td>
<td>79,647</td>
</tr>
<tr>
<td>4</td>
<td>–</td>
<td>24,835</td>
<td>5,376</td>
<td>30,211</td>
<td>79,647</td>
<td>109,858</td>
</tr>
<tr>
<td>5</td>
<td>–</td>
<td>24,835</td>
<td>7,416</td>
<td>32,251</td>
<td>109,858</td>
<td>142,109</td>
</tr>
<tr>
<td>6</td>
<td>20,000</td>
<td>–</td>
<td>9,593</td>
<td>9,593</td>
<td>142,109</td>
<td>131,702</td>
</tr>
<tr>
<td>7</td>
<td>20,000</td>
<td>–</td>
<td>8,890</td>
<td>8,890</td>
<td>131,702</td>
<td>120,592</td>
</tr>
<tr>
<td>8</td>
<td>20,000</td>
<td>–</td>
<td>8,140</td>
<td>8,140</td>
<td>120,592</td>
<td>108,732</td>
</tr>
<tr>
<td>9</td>
<td>20,000</td>
<td>–</td>
<td>7,339</td>
<td>7,339</td>
<td>108,732</td>
<td>96,071</td>
</tr>
<tr>
<td>10</td>
<td>20,000</td>
<td>–</td>
<td>6,485</td>
<td>6,485</td>
<td>96,071</td>
<td>82,556</td>
</tr>
<tr>
<td>11</td>
<td>20,000</td>
<td>–</td>
<td>5,572</td>
<td>5,572</td>
<td>82,556</td>
<td>68,128</td>
</tr>
<tr>
<td>12</td>
<td>20,000</td>
<td>–</td>
<td>4,599</td>
<td>4,599</td>
<td>68,128</td>
<td>52,727</td>
</tr>
<tr>
<td>13</td>
<td>20,000</td>
<td>–</td>
<td>3,559</td>
<td>3,559</td>
<td>52,727</td>
<td>36,286</td>
</tr>
<tr>
<td>14</td>
<td>20,000</td>
<td>–</td>
<td>2,449</td>
<td>2,449</td>
<td>36,286</td>
<td>18,735</td>
</tr>
<tr>
<td>15</td>
<td>20,000</td>
<td>–</td>
<td>1,265</td>
<td>1,265</td>
<td>18,735</td>
<td>0</td>
</tr>
<tr>
<td>Totals</td>
<td>200,000</td>
<td>124,175</td>
<td>75,825</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

No entry would be made at the inception date of the agreement. The following entry would be made in year 1 to record the service component of the compensation expense and related deferred compensation agreement liability:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation expense</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$24,835</td>
</tr>
<tr>
<td>Deferred compensation liability</td>
<td>$24,835</td>
</tr>
</tbody>
</table>

[To record the column B service component]

Similar entries would be made in year 2 through year 5 to record the service component of the compensation expense.

In each subsequent period, until the date the employee is fully eligible for the deferred compensation benefit, the company would adjust the deferred compensation liability for the total expense (the service and interest components). In each period after the full eligibility date, the company would adjust the deferred compensation liability for the interest component and any benefit payment. In addition, the company would reassess the assumptions used in determining the expected future benefits under the agreement and the discount rate used to compute the present value of the expected benefits in each period after the inception of the agreement, and revise the assumptions and rate, as appropriate.

Assuming no changes were necessary to the assumptions used to determine the expected
future benefits under the agreement or to the discount rate used to compute the present value of the expected benefits, the following entry would be made in year 2 to record the interest component of the compensation expense:

```
<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation expense</td>
<td>$1,676</td>
</tr>
<tr>
<td>Deferred compensation liability</td>
<td>$1,676</td>
</tr>
</tbody>
</table>
```

[To record the column C interest component (computed by multiplying the prior-year column F balance by the discount rate)]

Similar entries (but for different amounts) would be made in year 3 through year 15 to record the interest component of the compensation expense. The following entry would be made in year 6 to record the payment of the annual benefit:

```
<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred compensation liability</td>
<td>$20,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$20,000</td>
</tr>
</tbody>
</table>
```

[To record the column A benefit payment]

Similar entries would be made in year 7 through year 15 to record the payment of the annual benefit.
Assessment of Capital Adequacy
Effective date November 2020

PURPOSE OF CAPITAL

Although both bankers and bank regulators look carefully at the quality of bank assets and management and at the ability of the bank to control costs, evaluate risks, and maintain proper liquidity, capital adequacy is the area that triggers the most supervisory action, especially in view of the prompt-corrective-action (PCA) provision of section 38 of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. 1831o. The primary function of capital is to fund the bank’s operations, act as a cushion to absorb unanticipated losses and declines in asset values that may otherwise lead to material bank distress or failure, and provide protection to uninsured depositors and debt holders if the bank were to be placed in receivership. A bank’s solvency promotes public confidence in the bank and the banking system as a whole by providing continued assurance that the bank will continue to honor its obligations and provide banking services. By exposing stockholders to a larger percentage of any potential loss, higher capital levels reduce the subsidy provided to banks by the federal safety net.

Capital regulation is particularly important because deposit insurance and other elements of the federal safety net provide banks with an incentive to increase their leverage beyond what the market—in the absence of depositors protection—would permit. Additionally, banks’ higher capital levels can reduce the need for certain supervisory activities, thereby lowering the regulatory burden on supervised institutions.

OVERVIEW OF REGULATION Q
(12 CFR Part 217)

In 2013, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively the agencies) adopted a rule replacing their general risk-based capital requirements, advanced approaches capital requirements, market risk capital requirements, and leverage capital requirements. The Federal Reserve’s capital rule, Regulation Q, addresses weaknesses highlighted during the 2008–09 financial crisis by helping to ensure that the banking system is better able to absorb losses and continue to lend in future periods of economic stress. In addition, Regulation Q implements certain federal laws related to capital requirements and international regulatory capital standards adopted by the Basel Committee on Banking Supervision (BCBS).

Applicability of Regulation Q

Regulation Q applies on a consolidated basis to every Board-regulated institution (referred to as a “banking organization” in this section) that is:

- a state member bank;
- a bank holding company (BHC) domiciled in the United States that is not subject to 12 CFR part 225, appendix C,
- a covered savings and loan holding company (SLHC) domiciled in the United States.

Regulation Q does not apply to SLHCs substantially engaged in insurance underwriting or commercial activities, or to SLHCs that are insurance underwriting companies.

Components of Capital

Regulation Q provides a definition of capital and a framework for calculating risk-weighted assets

1. See 12 CFR part 217 (Regulation Q). For more information on the implementation of Regulation Q, see SR-15-6.


2. 12 CFR part 225, appendix C is the “Small Bank Holding Company and Savings and Loan Holding Company Policy Statement,” and it applies to BHCs with pro forma consolidated assets of less than $3 billion that (1) are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (2) do not conduct significant off-balance-sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; and (3) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission. The Board may, in its discretion, exclude any BHC, regardless of asset size, from the policy statement if such action is warranted for supervisory purposes. With some exceptions, the policy statement applies to SLHCs as if they were BHCs. See the Bank Holding Company Supervision Manual for more information on the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement. The Board may, by order, apply any or all of Regulation Q to any BHC, based on an institution’s asset size, level of complexity, risk profile, scope of operations, or financial condition.
by assigning assets and off-balance-sheet items to broad categories of credit risk. A banking organization’s risk-based capital ratio is calculated by dividing its qualifying capital (the numerator of the ratio) by its risk-weighted assets (the denominator). A summary of the components of qualifying capital is outlined below, as are the procedures for calculating risk-weighted assets. For more comprehensive information on the definition of capital and risk weighted assets, see the Federal Reserve’s Regulation Q.

The risk-based capital requirements of Regulation Q are designed to be sensitive to differences in credit-risk profiles among banking organizations; factor off-balance-sheet exposures into the assessment of capital adequacy; minimize disincentives to holding liquid, low-risk assets; and achieve consistency in the evaluation of the capital adequacy of major banking organizations worldwide.

The three components of regulatory capital are (1) common equity tier 1 capital, (2) additional tier 1 capital, and (3) tier 2 capital.

**Common Equity Tier 1 Capital**

Common equity tier 1 capital is defined as the sum of a banking organization’s outstanding common equity tier 1 capital instruments that satisfy the criteria set forth in Regulation Q (12 CFR 217.20(b)). Common equity tier 1 capital represents the highest-quality and most loss absorbing form of capital. The criteria for common equity tier 1 capital are designed to ensure that common equity tier 1 capital is available to absorb losses as they occur and that common equity tier 1 instruments do not possess features that would cause a banking organization’s condition to weaken further during periods of economic and market stress. Common equity tier 1 capital is primarily composed of common stock and retained earnings, plus limited amounts of minority interest in the form of common stock, less certain regulatory adjustments and deductions (e.g., goodwill).

Under the standardized approach of Regulation Q, banking organizations are not required to include all components of accumulated other comprehensive income (AOCI) in common equity tier 1 capital. For advanced approaches banking organizations, most AOCI components are included in common equity tier 1 capital.

**Additional Tier 1 Capital**

Additional tier 1 capital includes instruments that satisfy the criteria set forth in Regulation Q (12 CFR 217.20(c)). Additional tier 1 capital also includes surplus related to the issuance of additional tier 1 capital instruments, and limited amounts of tier 1 minority interest that are not included in a banking organization’s common equity tier 1 capital, less applicable regulatory adjustments and deductions. The eligibility criteria for additional tier 1 capital instruments are designed to ensure that additional tier 1 capital instruments would be available to absorb losses on a going-concern basis. Given the strict criteria, in the United States the only instrument includable in additional tier 1 capital is non-cumulative perpetual preferred stock. Cumulative preferred stock and trust preferred securities are generally not included in additional tier 1 capital.

**Tier 2 Capital**

Tier 2 capital consists of instruments that satisfy the criteria set forth in Regulation Q (12 CFR 217.20(d)). Tier 2 capital also includes surplus related to the issuance of tier 2 capital instruments; limited amounts of total capital minority interest not included in a banking organization’s tier 1 capital; and limited amounts of the allowance for loan and lease losses (ALLL), or adjusted allowances for credit losses (AACL), as applicable, less applicable regulatory adjustments.

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3. ALLL means valuation allowances that have been established through a charge against earnings to cover estimated credit losses on loans, lease financing receivables, or other extensions of credit as determined in accordance with GAAP. ALLL excludes “allocated transfer risk reserves.” For purposes of Regulation Q, ALLL includes allowances that have been established through a charge against earnings to cover estimated credit losses associated with off-balance-sheet credit exposures as determined in accordance with GAAP.

4. AACL means, with respect to a Board-regulated institution that has adopted current expected credit losses (CECL) methodology, valuation allowances that have been established through a charge against earnings or retained earnings for expected credit losses on financial assets measured at amortized cost and a lessor’s net investment in leases that have been established to reduce the amortized cost basis of the assets to amounts expected to be collected as determined in accordance with GAAP. AACL includes allowances for expected credit losses on off-balance-sheet credit exposures not accounted for as insurance as determined in accordance with GAAP. AACL excludes “allocated transfer risk reserves” and allowances created that reflect credit losses on purchased credit deteriorated assets and available-for-sale debt securi-
Adjustments and deductions. A banking organization calculating its total capital ratio using the standardized approach may include in tier 2 capital the amount of ALLL or AACL that does not exceed 1.25 percent of its standardized total risk-weighted assets.

A banking organization calculating its total capital ratio using the advanced approaches may include in tier 2 capital the excess of its eligible credit reserves over its total expected credit loss, provided the amount does not exceed 0.6 percent of its credit risk-weighted assets.

Deductions and Limits

Deductions from common equity tier 1 capital include goodwill and other intangibles (except mortgage servicing assets), deferred tax assets (DTAs) that arise from net operating loss and tax credit carryforwards (above certain levels), gains-on-sale in connection with a securitization, any defined benefit pension fund net asset (for banking organizations that are not insured depository institutions), investments in a banking organization’s own capital instruments, mortgage servicing assets (above certain levels) and investments in the capital of unconsolidated financial institutions (above certain levels). Mortgage servicing assets, DTAs arising from temporary differences that the banking organization could not realize through net operating loss carrybacks, and certain investments in financial institutions are each limited to 10 percent of common equity tier 1 capital and in combination are limited to 15 percent of common equity tier 1 capital.

Risk-Weighted Assets

Regulation Q prescribes two approaches to risk weighting assets. The standardized approach is generally designed for smaller banking organizations, while the advanced approaches are used by larger, more complex institutions.

Standardized Approach

The standardized approach described in Regulation Q harmonizes the agencies’ calculation of risk-weighted assets and addresses shortcomings in previous risk-based capital requirements by increasing the capital requirements for certain assets. In addition, the standardized approach serves as a floor pursuant to section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) with respect to risk-based capital requirements that the Federal Reserve may establish for BHCs, any non-bank financial company designated by the Financial Stability Oversight Council, SLHCs, and state member banks.

Under the standardized approach, higher risk weights generally apply to high volatility commercial real estate loans, past due loans, and certain equity and securitization exposures. The standardized approach also provides recognition of collateral and guarantees and incentives for derivatives and repo-style transactions cleared through central counterparties.

Below is a list of some key assets and exposures and the risk weights to which they are assigned under the standardized approach.

- **Public sector entities and U.S. government sponsored entities.** Exposures to the U.S. government generally receive a zero percent risk weight, and exposures to U.S. public-sector entities (PSEs), U.S. government-sponsored entities (GSEs), and U.S. depository institutions generally receive a 20 percent risk weight. Exposures conditionally guaranteed by the U.S. government and its agencies generally receive a 20 percent risk weight.

- **Exposures to sovereign entities.** Regulation Q provides that Organization for Economic Co-operation and Development (OECD) member countries without a country risk classifications (CRC) rating receive a risk weight of zero percent while nonmember countries without a CRC rating will receive a risk weight of 100 percent. Exposures to sovereign entities with a CRC rating are to be assigned the risk weight that corresponds to the CRC ratings. Additionally, if an event of sovereign default has occurred in the foreign bank’s home country within the last five years, a banking organization must assign a 150 percent risk weight to the exposure.
• **High volatility commercial real estate loans (HVCRE).** In general, HVCRE exposures include any credit facility that finances or has financed the acquisition, development, or construction of real property, unless the facility finances one- to four-family residential mortgage property, loans to finance agricultural properties, or certain community development projects, or commercial real estate projects that meet certain prudential criteria, including the loan-to-value (LTV) ratio for a loan and capital contributions or expense contributions of the borrower. Supervisory experience has demonstrated that certain acquisition, development, and construction loans, which are a subset of commercial real estate exposures, present particular risks for banking organizations. Accordingly, HVCRE is assigned a 150 percent risk weight under Regulation Q.

• **Residential mortgage exposures.** One-to four-family residential mortgage exposures are generally assigned a 50 percent risk weight under Regulation Q provided the exposures are prudently underwritten first lien mortgage loans that are not past due, reported as nonaccrual, secured by a property that is either owner-occupied or rented, and has not been restructured or modified. A 100 percent risk weight is assigned for all other residential mortgages.

• **Structured securities and securitizations.** The securitization framework in Regulation Q addresses the credit risk of exposures that involve the tranching of credit risk of one or more underlying financial exposures. Regulation Q defines a securitization exposure as an on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional or synthetic securitization (including a resecuritization), or an exposure that directly or indirectly references a securitization exposure.

Regulation Q establishes risk weight approaches for securitization exposures and structured security exposures that are retained on- or off-balance sheet. Typical examples of securitization exposures include private label collateralized mortgage obligations (CMOs), trust preferred collateralized debt obligations, and asset-backed securities, provided there is tranching of credit risk. Generally, pass-through and government agency CMOs are excluded from the securitization exposure risk weight approaches. In general, Regulation Q requires banking organizations to calculate the risk weight of securitization exposures using either the gross-up approach or the Simplified Supervisory Formula Approach (SSFA) consistently across all securitization exposures, except in certain cases. For instance, the bank can, at any time, risk-weight a securitization exposure at 1,250 percent.

The gross-up approach is similar to earlier risk-based capital rules, where capital is required on the credit exposure of the bank’s investment in a specific tranche as well as its pro rata share of the more senior tranches that its tranche supports. A bank calculates its capital requirement based on the weighted-average risk weights of the underlying exposures in the securitization pool.

The SSFA is designed to assign a lower risk weight to more-senior-class securities and higher risk weights to supporting tranches. The SSFA is both risk-sensitive and forward-looking. The formula adjusts the risk weight for a security based on key risk factors such as incurred losses on the underlying assets, nonperforming loans, and the ability of subordinate tranches to absorb losses. In any case, a securitization exposure is assigned a risk weight of no lower than 20 percent.

• **Securitization due diligence.** During the 2008-09 financial crisis, many banking organizations relied exclusively on ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs) and did not perform internal credit analysis of their securitization exposures. Consistent with the Basel capital framework and the agencies’ general expectations for investment analysis, Regulation Q outlines specific securitization exposure due diligence requirements for banking organizations. As stated in Regulation Q, a banking
organization is required to demonstrate, to the satisfaction of its primary federal supervisor, a comprehensive understanding of the features of a securitization exposure that would materially affect its performance. The banking organization’s analysis must be commensurate with the complexity of the exposure and the materiality of the exposure in relation to capital of the banking organization. On an ongoing basis (no less frequently than quarterly), the banking organization must evaluate, review, and update as appropriate the analysis required by Regulation Q (12 CFR 217.41(c)(1)) for each securitization exposure. The analysis of the risk characteristics of the exposure prior to acquisition, and periodically thereafter, need to consider:

— Structural features of the securitization that materially impact the performance of the exposure. For example, the contractual cash-flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

— Relevant information regarding the performance of the underlying credit exposure(s). For example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average LTV ratio; and industry and geographic diversification data on the underlying exposure(s);

— Relevant market data of the securitization. For example, bid-ask spread; most recent sales price and historical price volatility; trading volume; implied market rating; and size, depth, and concentration level of the market for the securitization; and

— For resecuritization exposures, performance information on the underlying securitization exposures. For example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the securitization exposures.

If a banking organization is not able to meet these due diligence requirements and demonstrate a comprehensive understanding of a securitization exposure to the satisfaction of its primary federal supervisor, the banking organization is required to assign a risk weight of 1,250 percent to the exposure.

• Equity exposures to investment funds. A banking organization determines the risk-weighted asset amount for equity exposures to investment funds using one of three approaches: (1) the full look-through approach, (2) the simple modified look-through approach, or (3) the alternative modified look-through approach, unless the equity exposure to an investment fund is a community development equity exposure. The risk-weighted asset amount for such community development equity exposures is the exposure’s adjusted carrying value. If a banking organization does not use the full look-through approach, and an equity exposure to an investment fund is part of a hedge pair, a banking organization must use the ineffective portion of the hedge pair as the adjusted carrying value for the equity exposure to the investment fund. The risk-weighted asset amount of the effective portion of the hedge pair is equal to its adjusted carrying value. A banking organization may choose which approach to apply for each equity exposure to an investment fund.

1. Full Look-Through Approach. A banking organization may use the full look-through approach only if the banking organization is able to calculate a risk-weighted asset amount for each of the exposures held by the investment fund. A banking organization using the full look-through approach is required to calculate the risk-weighted asset amount for its proportionate ownership share of each of the exposures held by the investment fund (as calculated under the standardized approach) as if the proportionate ownership share of the adjusted carrying value of each exposures were held directly by the banking organization. The banking organization’s risk-weighted asset amount for the exposure to the fund is equal to (1) the aggregate risk-weighted asset amount of the exposures held by the fund as if they were held directly by the banking organization multiplied by (2) the banking organization’s proportional ownership share of the fund.

2. Simple Modified Look-Through Approach. Under the simple modified look-through
approach, a banking organization sets the risk-weighted asset amount for its equity exposure to an investment fund equal to the adjusted carrying value of the equity exposure multiplied by the highest applicable risk weight under the standardized approach to any exposure that is permitted to hold under the prospectus, partnership agreement, or similar agreement that defines the fund’s permissible investments. The banking organization may exclude derivative contracts held by the fund that are used for hedging, rather than for speculative purposes, and do not constitute a material portion of the fund’s exposures.

3. **Alternative Modified Look-Through Approach.** Under the alternative modified look-through approach, a banking organization may assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk weight categories under the standardized approach based on the investment limits in the fund’s prospectus, partnership agreement, or similar contract that defines the fund’s permissible investments. The risk-weighted asset amount for the banking organization’s equity exposure to the investment fund is equal to the sum of each portion of the adjusted carrying value assigned to an exposure type multiplied by the applicable risk weight. If the sum of the investment limits for all permissible investments within the fund exceeds 100 percent, the banking organization must assume that the fund invests to the maximum extent permitted under its investment limits in the exposure category with the highest applicable risk weight under the standardized approach and continues to make investments in the order of the exposure category with the next highest risk weight until the maximum total investment level is reached. If more than one exposure category applies to an exposure, the banking organization must use the highest applicable risk weight. A banking organization may exclude derivative contracts held by the fund that are used for hedging, rather than for speculative purposes, and do not constitute a material portion of the fund’s exposures.

**Collateralized transactions.** Regulation Q recognizes a range of financial collateral as credit risk mitigants that may reduce the risk-based capital requirements associated with a collateralized transaction. Financial collateral includes

1. cash on deposit with the banking organization (including cash held for the banking organization by a third-party custodian or trustee);
2. gold bullion;
3. short- and long-term debt securities that are not securitization exposures and that are investment grade;
4. equity securities that are publicly traded;
5. convertible bonds that are publicly traded; or
6. money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily.

With the exception of cash on deposit, the banking organization is also required to have a perfected, first-priority security interest or, outside of the United States, the legal equivalent thereof, notwithstanding the prior security interest of any custodial agent. Even if a banking organization has the legal right, it still must ensure it monitors or has a freeze on the account to prevent a customer from withdrawing cash on deposit prior to defaulting. A banking organization is permitted to recognize partial collateralization of an exposure.

Under Regulation Q, a banking organization may recognize the risk-mitigating effects of financial collateral using the “simple approach” for any exposure provided that the collateral meets certain requirements. For repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions, a banking organization could alternatively use the “collateral haircut approach.” Most institutions are likely to use the simple approach; however, regardless of the approach chosen, the institution must consistently apply its approach for similar exposures or transactions.

**Simple approach.** In the simple approach described in Regulation Q, the collateralized portion of the exposure receives the
risk weight applicable to the collateral. The collateral is required to meet the definition of financial collateral. For repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions, the collateral would be the instruments, gold, and cash that a banking organization has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction. In all cases, (1) the collateral must be subject to a collateral agreement for at least the life of the exposure; (2) the banking organization must revalue the collateral at least every six months; and (3) the collateral (other than gold) and the exposure must be denominated in the same currency. Generally, the risk weight assigned to the collateralized portion of the exposure must be no less than 20 percent. However, the collateralized portion of an exposure may be assigned a risk weight of less than 20 percent in certain instances.

- **Collateral haircut approach.** A banking organization may use the collateral haircut approach to recognize the credit risk mitigation benefits of financial collateral that secures an eligible margin loan, repo-style transaction, collateralized derivative contract, or single-product netting set of such transactions. In addition, the banking organization may use the collateral haircut approach with respect to any collateral that secures a repo-style transaction that is included in the banking organization’s value-at-risk (VaR)-based measure under the market risk rule, even if the collateral does not meet the definition of financial collateral. To apply the collateral haircut approach, a banking organization must determine the exposure amount and the relevant risk weight for the counterparty or guarantor. The exposure amount for an eligible margin loan, repo-style transaction, collateralized derivative contract, or a netting set of such transactions is equal to the greater of zero and the sum of the following three quantities as described in Regulation Q (12 CFR 217.37(e)): (1) the value of the exposure less the value of the collateral; (2) the absolute value of the net position in a given instrument or in gold; and (3) the absolute value of the net position of instruments and cash in a currency that is different from the settlement currency multiplied by the haircut appropriate to the currency mismatch.

For purposes of the collateral haircut approach, a given instrument includes, for example, all securities with a single Committee on Uniform Securities Identification Procedures (CUSIP) number and would not include securities with different CUSIP numbers, even if issued by the same issuer with the same maturity date.

- **Treatment of Guarantees.** Under Regulation Q, banking organizations have the option to substitute the risk weight of an eligible guarantee or guarantor for the risk weight of the underlying exposure. For example, if the bank has a loan guaranteed by an eligible guarantor, the bank can use the risk weight of the guarantor. Eligible guarantors include entities such as depository institutions and holding companies, the International Monetary Fund, Federal Home Loan Banks, the Federal Agricultural Mortgage Corporation, entities with investment grade debt, sovereign entities, and foreign banks. An eligible guarantee must be written, be either unconditional or a contingent obligation of the U.S. government or its agencies, cover all or a pro rata share of all contractual payments, give the beneficiary a direct claim against the protection provider, and meet other requirements outlined in the definition of eligible guarantees in 12 CFR 217.2.

- **Off-Balance-Sheet Exposures.** Risk-weighted asset amounts for off-balance-sheet items are calculated using a two-step process: (1) Multiplying the amount of the off-balance-sheet exposure by a credit conversion factor to determine a credit equivalent amount, and (2) assigning the credit equivalent amount to a relevant risk-weight category. This treatment applies to all off-balance-sheet items, such as commitments, contingent items, guarantees, certain repo-style transactions, financial standby letters of credit, and forward agreements.
### Table 1—SUMMARY OF STANDARDIZED APPROACH RISK WEIGHTS OF ASSETS IN 12 CFR 217

<table>
<thead>
<tr>
<th>Category</th>
<th>Risk weight</th>
<th>Section of the rule (12 CFR 217)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>0%</td>
<td>217.32(1)(1)</td>
</tr>
<tr>
<td>Direct and unconditional claims on the U.S. government, its agencies,</td>
<td>0%</td>
<td>217.32(a)(1)(i)</td>
</tr>
<tr>
<td>and the Federal Reserve</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Claims on certain supranational entities and multilateral development</td>
<td>0%</td>
<td>217.32(b)</td>
</tr>
<tr>
<td>banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash items in the process of collection</td>
<td>20%</td>
<td>217.32</td>
</tr>
<tr>
<td>Conditional claims on the U.S. government</td>
<td>20%</td>
<td>217.32(a)(1)(ii)</td>
</tr>
<tr>
<td>Claims on government-sponsored enterprises (GSEs)</td>
<td>20% on exposures other than equity exposures and preferred stock. 100% on GSE preferred stock.</td>
<td>217.32(c)</td>
</tr>
<tr>
<td>Claims on U.S. depository institutions and National Credit Union</td>
<td>20%</td>
<td>217.32(d)(1) and (3)</td>
</tr>
<tr>
<td>Administration-insured credit unions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Claims on U.S. public sector entities</td>
<td>20% for general obligations. 50% for revenue obligations.</td>
<td>217.32(e)(1)</td>
</tr>
<tr>
<td>Industrial development bonds</td>
<td>100%</td>
<td>217.32(l)(5)</td>
</tr>
<tr>
<td>Claims on qualifying securities firms</td>
<td>100% – See corporate exposures below.</td>
<td>217.32(f)</td>
</tr>
<tr>
<td>One- to four-family loans</td>
<td>50% if first lien, prudently underwritten, owner occupied or rented, not 90 days or more past due or carried in nonaccrual status, is not restructured or modified. 100% otherwise.</td>
<td>217.32(g)</td>
</tr>
<tr>
<td>One- to four-family loans modified under Home Affordable Modification</td>
<td>50% and 100%</td>
<td>217.32(g)(3)</td>
</tr>
<tr>
<td>Program</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Category</td>
<td>Risk weight</td>
<td>Section of the rule</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------</td>
<td>---------------------</td>
</tr>
<tr>
<td>Loans to builders secured by one- to four-family properties pre-sold</td>
<td>50% if the loan meets all criteria in the regulation. 100% if the contract is cancelled. 100% for</td>
<td>217.32(h)</td>
</tr>
<tr>
<td>under firm contracts</td>
<td>loans not meeting the criteria.</td>
<td></td>
</tr>
<tr>
<td>Loans on multifamily properties</td>
<td>50% if the loan meets all the criteria in the regulation for a statutory multifamily property; 100%</td>
<td>217.32(i)</td>
</tr>
<tr>
<td></td>
<td>otherwise.</td>
<td></td>
</tr>
<tr>
<td>Corporate exposures and consumer loans</td>
<td>100% unless the exposure is an investment in an instrument included in the regulatory capital of</td>
<td>217.32(f)</td>
</tr>
<tr>
<td></td>
<td>another financial institution.</td>
<td></td>
</tr>
<tr>
<td>Commercial real estate (CRE)</td>
<td>100% 150% for high volatility commercial real estate, which is, subject to certain exceptions, a</td>
<td>217.32(j) and (l)(5)</td>
</tr>
<tr>
<td></td>
<td>credit facility secured by land or improved real property that primarily finances has financed, or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>refines the acquisition, development, or construction of real property; has the purpose of</td>
<td></td>
</tr>
<tr>
<td></td>
<td>providing financing to acquire, develop, or improve such real property into income-producing real</td>
<td></td>
</tr>
<tr>
<td></td>
<td>property; and is dependent upon future income or sales proceeds from, or refinancing of, such real</td>
<td></td>
</tr>
<tr>
<td></td>
<td>property for the repayment of such credit facility.</td>
<td></td>
</tr>
<tr>
<td>Past-due exposures</td>
<td>150% for the portion that is not guaranteed or secured (does not apply to sovereign exposures).</td>
<td>217.32(k)</td>
</tr>
<tr>
<td></td>
<td>However, one- to four-family loans that are past due 90 days or more are assigned a 100% risk</td>
<td></td>
</tr>
<tr>
<td></td>
<td>weight.</td>
<td></td>
</tr>
<tr>
<td>Assets not assigned to a risk weight category, including fixed assets,</td>
<td>100%</td>
<td>217.32(l)(5)</td>
</tr>
<tr>
<td>premises, and other real estate owned</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage-backed securities, asset-backed securities, and structured</td>
<td>Two general approaches—gross-up approach and simple supervisory formula approach. May also choose</td>
<td>217.42, .43, and .44</td>
</tr>
<tr>
<td>securities</td>
<td>risk weight a securitization exposure at 1,250%.</td>
<td></td>
</tr>
</tbody>
</table>
### Equity exposures

**Range of risk weights between 0% and 600%, depending on the entity and whether the equity is publicly traded**

#### Equity exposures to investment funds

There is a 20% risk weight floor on investment fund holdings. The following approaches are available:

1. Risk weight is the same as the highest risk weight investment the fund is permitted to hold (called the Simple Modified Look-Through Approach).
2. A banking organization may assign risk weight on a pro rata basis based on the investment limits in the fund’s prospectus (called the Alternative Modified Look-Through Approach).
3. A third treatment (called the Full Look-Through Approach) risk weights each asset of the fund (as if owned directly) and multiplies by the banking organization’s proportional ownership in the fund.

### Claims on foreign governments and their central banks, foreign banking organizations, and foreign public sector entities

Risk weight depends on Country Risk Classification (CRC) applicable to the sovereign, the sovereign’s OECD status, and whether the sovereign entity has defaulted within the previous five years.

### Advanced Approaches

The advanced approaches framework provides a risk-based and leverage capital framework that permit certain banking organizations to use an internal risk measurement approach to calculate capital requirements and advanced measurement approaches in order to calculate regulatory operational-risk capital requirements. An advanced approaches banking organization must calculate its risk-based capital ratios using both the standardized and advanced approaches and meet each minimum requirement with the lower of the two ratios. The advanced approaches are supplemented by the market risk capital requirement.

The advanced approaches in Regulation Q (12 CFR part 217) apply to a top-tier U.S. bank holding companies or savings and loan holding company that is identified as a global systemically important bank holding company and a Category II banking organization as described in the Federal Reserve’s Regulation YY (12 CFR 252.5) or Regulation LL (12 CFR 238.10). The advanced approaches also apply to a state member bank that is a subsidiary of a global systemically important bank holding company, a Category II Board-regulated institution; or a

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6. See 12 CFR part 217 subpart E.
subsidiary of a bank, bank holding company, or savings and loan holding company that uses the advanced approaches to calculate its risk-based capital requirements. Advanced approaches banking organizations also include those banking organizations that have elected to use the advanced approaches to calculate their total risk-weighted assets.

**Market Risk Capital Requirement**

The market risk capital requirement\(^7\) applies to banking organizations with significant trading activities to calculate regulatory capital requirements for market risk. The purpose of the market risk capital requirement is to establish risk-based capital requirements for Board-regulated institutions with significant exposure to market risk, provide methods for these Board-regulated institutions to calculate their standardized measure for market risk and, if applicable, advanced measure for market risk, and establish public disclosure requirements. The market risk capital requirement applies to any Board-regulated institution with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets or $1 billion or more.\(^8\) On a case-by-case basis, the Federal Reserve may require an institution that does not meet these criteria to comply with the market risk capital requirement if deemed necessary for safety-and-soundness reasons. The Federal Reserve may also exclude an institution that meets the criteria if such exclusion is deemed to be consistent with safe and sound banking practices.

**Minimum Regulatory Capital Ratios**

All banking organizations covered under Regulation Q are subject to the following minimum regulatory capital requirements: a common equity tier 1 capital ratio of 4.5 percent, a tier 1 capital ratio of 6 percent, a total capital ratio of 8 percent of risk-weighted assets, and a leverage ratio of 4 percent.\(^9\) See table 2 for more information on the calculation of these ratios.

Most banking organizations are expected to operate with capital levels above the minimum ratios. Banking organizations that are undertaking significant expansion or that are exposed to high or unusual levels of risk are expected to maintain capital well above the minimum ratios; in such cases, the Federal Reserve may specify a higher minimum requirement.

In implementing Regulation Q, the Federal Reserve has reserved the authority to require banking organizations to hold more capital if the minimum requirements are not commensurate with the bank’s credit, market, operational, or other risks (see 12 CFR 217.1(d)). This is a formal process that requires Federal Reserve approval, and an examiner alone cannot provide this directive. Examiners may use the Matters Requiring Attention or Matters Requiring Immediate Attention section of the examination report to require a bank to maintain an appropriate capital policy or plan that includes capital limits that are consistent with the bank’s risk profile.

**Community Bank Leverage Ratio Framework**

In 2019, the agencies adopted a final rule\(^10\) that provides for a simple measure of capital adequacy for certain community banking organizations, consistent with section 201 of the EGRRCPA. This final rule established the community bank leverage ratio (CBLR) framework, which provides an optional measure of capital adequacy for depository institutions and depository institution holding companies with the following characteristics:

- leverage ratio greater than 9 percent\(^11\)
- less than $10 billion in average total consolidated assets
- off-balance-sheet exposures of 25 percent or less of total consolidated assets
- trading assets plus trading liabilities of 5 percent or less of total consolidated assets
- not an advanced approaches banking organization\(^12\)

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7. See 12 CFR part 217 subpart F.
8. As reported in the Board-regulated institution’s most recent quarterly Call Report, for a state member bank, or Form FR Y-9C, for a BHC or SLHC, as applicable, any SLHC that does not file the Form FR Y-9C should follow the instructions to the Form FR Y-9C.
9. Tier 1 capital is equal to the sum of common equity tier 1 capital and additional tier 1 capital. Total capital is the sum of common equity tier 1, additional tier 1, and tier 2 capital.
12. For more detailed information on the applicability of
A qualifying banking organization may opt into the CBLR framework by completing the associated reporting line items that are required for such firms on its Call Report and/or Form FR Y–9C, as applicable. A qualifying banking organization that elects to use the CBLR framework and that maintains a leverage ratio of greater than 9 percent will be considered to have satisfied the generally applicable risk-based and leverage capital requirements in the agencies’ capital rules (generally applicable requirement). If applicable, the qualifying banking organization will be considered to have met the well-capitalized ratio requirements for prompt corrective action purposes.

A banking organization may opt out of the CBLR framework and become subject to the generally applicable requirement by completing the associated reporting requirements on its Call Report and/or Form FR Y–9C, as applicable. A banking organization can opt out of the CBLR framework between reporting periods by providing its capital ratios under the generally applicable requirement to its appropriate regulators at that time.

Calculation of the CBLR is as follows:

\[
\text{Tier 1 capital} \quad \text{Average total consolidated assets}
\]

The calculation of a Board-regulated institution’s leverage ratio is described in the generally applicable requirement. However, the calculation of tier 1 capital for purposes of the CBLR differs from the generally applicable requirement. Because the CBLR framework does not have a total capital requirement, an electing banking organization is neither required to calculate tier 2 capital nor make any deductions that would have been taken from tier 2 capital under the generally applicable requirement.

Grace Period

If an electing banking organization fails to satisfy one or more of the qualifying criteria but maintains a leverage ratio of greater than 8 percent, that banking organization has a “grace period” of up to two quarters during which it could continue to use the CBLR framework and be deemed to meet the “well capitalized” capital ratio requirements. As long as the banking organization is able to return to compliance with all the qualifying criteria within two quarters, it continues to be deemed to meet the “well capitalized” ratio requirements and to be in

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**TABLE 2—CAPITAL RATIO CALCULATIONS AND MINIMUM RATIOS**

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Calculation</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common equity tier 1 capital ratio</td>
<td>(\frac{\text{common equity tier 1 capital}}{\text{standardized total risk-weighted assets}})</td>
<td>4.5%</td>
</tr>
<tr>
<td>Tier 1 capital ratio</td>
<td>(\frac{\text{tier 1 capital}}{\text{standardized total risk-weighted assets}})</td>
<td>6%</td>
</tr>
<tr>
<td>Total capital ratio</td>
<td>(\frac{\text{total capital}}{\text{standardized total risk-weighted assets}})</td>
<td>8%</td>
</tr>
<tr>
<td>Leverage ratio</td>
<td>(\frac{\text{tier 1 capital}}{\text{average total consolidated assets}})</td>
<td>4%</td>
</tr>
</tbody>
</table>

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compliance with the generally applicable requirement.

A banking organization is required to comply with and report under the generally applicable requirement and file the relevant regulatory reports if the banking organization (1) is unable to restore compliance with all qualifying criteria during the two-quarter grace period (including reporting a leverage ratio greater than 9 percent), (2) has a leverage ratio of 8 percent or less, or (3) ceases to satisfy the qualifying criteria due to consummation of a merger transaction.16

**Supplementary Leverage Ratio**

The supplementary leverage ratio measures tier 1 capital relative to total leverage exposure, which includes on-balance sheet assets (including deposits at central banks) and certain off-balance sheet exposures.17

Advanced approaches banking organizations and Category III Board-regulated institutions are also subject to a minimum supplementary leverage ratio of 3 percent. The denominator of the supplementary leverage ratio incorporates certain off-balance-sheet exposures such as commitments and derivative exposures. The Federal Reserve applies this to advanced approaches banking organizations and Category III Board-regulated institutions because these firms typically hold higher levels of off-balance-sheet exposure that are not captured by the leverage ratio. The supplementary leverage ratio also factors into a covered institution’s PCA capital ratio framework.

In January 2020, the Federal Reserve issued a final rule to implement EGRRCPA section 402, which requires the agencies to amend the supplementary leverage ratio.18 Under EGRRCPA section 402, the supplementary leverage ratio must not take into account funds of a custodial bank that are deposited with certain central banks, provided that any amount that exceeds the value of deposits of the custodial bank that are linked to fiduciary or custodial and safekeeping accounts must be taken into account when calculating the supplementary leverage ratio as applied to the custodial bank. Custody, safekeeping, and asset servicing activities generally involve holding securities or other assets on behalf of clients, as well as activities such as transaction settlement, income processing, and related record keeping and operational services. To qualify as a custodial banking organization, a depository institution holding company is required to have a ratio of assets under custody-to-total assets of at least 30:1, calculated as an average over the prior four calendar quarters.

**Enhanced Supplementary Leverage Ratio**

In 2015, the Federal Reserve implemented an enhanced supplemental leverage ratio requirement.19 Banking organizations subject to Category I standards, which are the global systemically important bank holding companies (U.S. G-SIBs), as well as their depository institution subsidiaries, are subject to enhanced supplementary leverage ratio standards. The enhanced supplementary ratio standards require each U.S. G-SIB to maintain a supplementary leverage ratio above 5 percent to avoid limitations on the firm’s distributions and certain discretionary bonus payments and also require each of its insured depository institutions to maintain a supplementary leverage ratio of at least 6 percent to be deemed “well capitalized” under the prompt corrective action framework of each agency. The leverage buffer functions like the capital conservation buffer for the risk-based capital ratios, which is described in greater detail below.

**De Novo Bank Leverage Ratio**

SR-20-16, “Supervision of De Novo State Member Banks,” provides additional supervisory guidance on leverage ratio expectations for de novo state member banks (de novo bank). As noted in SR-20-16, an insured depository institution is considered to be in the de novo stage until it has been operating for at least three years. A de novo bank should maintain capital ratios commensurate with its risk profile and, generally, well in excess of regulatory minimums. Typically, as a condition of membership, the Federal Reserve requires each de novo bank to maintain a Tier 1 leverage ratio of at least 8 percent for the first three years of its exis-

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17. 12 CFR 217.10(a)(5) and (c)(4).
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 novo banks that rely on additional capital infusions to meet this minimum requirement and understand the stability of the capital source.

**Stress Capital Buffer**

During the 2008–09 financial crisis, some banking organizations continued to pay dividends and substantial discretionary bonuses even as their financial condition weakened. Such capital distributions had a significant negative impact on the overall strength of the banking sector. To encourage better capital conservation and to enhance the resilience of the banking system, Regulation Q limits capital distributions and discretionary bonus payments for banking organizations that do not hold a specified amount of common equity tier 1 capital in addition to the amount of regulatory capital necessary to meet the minimum risk-based capital requirements (capital conservation buffer).

On March 4, 2020, the Federal Reserve approved a final rule establishing a stress capital buffer for bank holding companies and U.S. intermediate holding companies of foreign banking organizations that have $100 billion or more in total consolidated assets. The stress capital buffer rule integrates the Federal Reserve’s stress test results with its non-stress capital requirements.

More specifically, the stress capital buffer rule integrates the Comprehensive Capital Analysis and Review (CCAR) with the capital rule. Under the stress capital buffer requirement, the Federal Reserve uses the results of its supervisory stress test to establish the size of a firm’s stress capital buffer requirement, which replaces the static 2.5 percent of risk-weighted assets component of a firm’s capital conservation buffer requirement. A firm’s stress capital buffer requirement varies based on a firm’s risk. A firm that does not maintain capital ratios above its minimums plus its buffer requirements faces restrictions on its capital distributions and discretionary bonus payments.

**Countercyclical Capital Buffer**

The countercyclical capital buffer (CCyB) is a supplemental policy tool that the Federal Reserve can increase during periods of rising vulnerabilities in the financial system and reduce when vulnerabilities recede. It is designed to increase the resilience of advanced approaches banking organizations or Category III Board-regulated institutions when there is an elevated risk of above-normal losses. Increasing the resilience of such organizations will, in turn, improve the resilience of the broader financial system. The circumstances in which the Federal Reserve would most likely begin to increase the CCyB above zero percent to augment minimum capital requirements and other capital buffers would be when systemic vulnerabilities are meaningfully above normal. By requiring large banking organizations to hold additional capital during a period of excess and removing the requirement to hold additional capital when the vulnerabilities have diminished, the CCyB is expected to moderate fluctuations in the supply of credit over time.

A CCyB, if applicable, would expand the capital conservation buffer by up to 2.5 percent of a banking organization’s total risk-weighted assets for advanced approaches banking organizations or Category III Board-regulated institutions. The amount of the CCyB amount is determined by a country’s bank supervisor and will differ by jurisdiction. At any point in time, a country’s bank supervisor determines the degree of excessive credit growth in its jurisdiction. An advanced approaches Board-regulated institution or a Category III Board-regulated institution must calculate a countercyclical capital buffer amount in accordance with Regulation Q (12 CFR 217.11(b)) for purposes of determining its maximum payout ratio. The payout ratio is set forth in Regulation Q as well as this manual’s section entitled “Dividends.”

**PROMPT CORRECTIVE ACTION**

In 1991, Congress enacted a regulatory framework to address the problems associated with troubled insured depository institutions with the intent of minimizing the long-term cost to the Deposit Insurance Fund. This legislation, the Federal Deposit Insurance Corporation Improvement Act of 1991, added section 38 to the
Federal Deposit Insurance Act (FDIA), codified at 12 U.S.C. 1831o; FDIA section 38 is known as the PCA statute. The Federal Reserve has implemented PCA as applicable to state member banks in subpart D of Regulation H (12 CFR 208.40 to 208.45). PCA uses the total risk-based capital measure, tier 1 risk-based capital measure, common equity tier 1 risk-based capital measure, leverage ratio, supplemental leverage ratio, and tangible equity to total assets ratio for assigning state member banks to the five capital categories. These five PCA categories under FDIA section 38 and the PCA regulations are “well capitalized,” “adequately capitalized,” “significantly undercapitalized,” and “critically undercapitalized.” A qualifying community banking organization that has elected to use the community bank leverage ratio framework under 12 CFR 217.12 is considered to have met the capital ratio requirements for the well capitalized capital category. The capital ratios trigger specific actions that are designed to restore a bank to financial health. See the “Prompt Corrective Action” section for more information on PCA.

EVALUATING CAPITAL ADEQUACY

Overall Assessment of Capital Adequacy

The following factors should be taken into account in assessing the overall capital adequacy of a bank.

Regulatory Capital Ratios

Capital ratios should be compared with regulatory minimums and with peer-group averages. Banking organizations are expected to maintain minimum capital ratios described above. However, because risk-based capital does not take explicit account of the quality of a bank’s asset portfolios or its risk exposures, such as interest-rate, liquidity, market, or operational risks, banking organizations are generally expected to operate with capital positions above the minimum ratios. Institutions with high or inordinate levels of risk are also expected to maintain capital well above the minimum levels.

Impact of Management

Strategic capital planning. One of management’s most important functions is to lead the organization by designing and implementing an effective strategic plan that addresses the bank’s capital requirements to support its business goals and objectives. The strategic plan should clearly outline the bank’s capital base, anticipated capital expenditures, desirable capital level, and external capital sources. Effective strategic planning allows the institution to be proactive in addressing market changes and emerging risks and, therefore, enables an institution to plan for its capital needs. Strategic capital planning should address both a bank’s short-term and long-term capital needs in relation to its asset deployment, funding sources, capital formation, management, marketing, operations, and information systems.

Growth. Capital is necessary to support a bank’s growth, and, therefore, a bank needs to monitor its capital ratios in relation to its strategic plan. Because a bank has to maintain a minimum ratio of capital to assets, there are limitations on a bank’s ability to grow. For example, a rapid growth in a bank’s loan portfolio may be a cause of concern, for it could indicate that a bank is altering its risk profile by reducing its underwriting standards.

Dividends. State member banks are subject to legal restrictions on reductions in capital resulting from cash dividends, including out of the capital surplus account, under 12 U.S.C. 324 and 12 CFR 208.5. The Federal Reserve has a long-standing policy statement on the payment of cash dividends by state member banks and BHCs that are experiencing financial difficulties. The policy statement addresses the following practices that raise supervisory concerns when an institution is experiencing earnings weaknesses, or has other serious problems or inadequate capital:

- the payment of dividends not covered by earnings.

22. For more information about capital planning at the holding company level, see SR-09-4, “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies,” and the Board’s Regulation Y on capital planning and stress capital buffer requirements (12 CFR 225.8).
the payment of dividends from borrowed funds, and
the payment of dividends from unusual or nonrecurring gains, such as the sale of property or other assets.

When a bank is experiencing earnings weaknesses or other financial pressures, the Federal Reserve’s view is that
• a bank’s level of cash dividends should not exceed its net income;
• dividends should be consistent with the organization’s capital position, and
• dividends should only be funded in ways that do not weaken the organization’s financial health.

In some instances, it may be appropriate to eliminate cash dividends altogether.  
Examiners should review historical and planned cash-dividend payout ratios to determine whether dividend payments are impairing capital adequacy. Excessive dividend payouts may result from several sources:

• If the bank is owned by a holding company, the holding company may be requiring excessive dividend payments from the bank to fund the holding company’s debt-repayment program, expansion goals, or other cash needs.
• The bank’s board of directors may be under pressure from individual shareholders to provide funds to repay bank stock debt or to use for other purposes.
• Dividends may be paid or promised to support a proposed equity offering.

Access to additional capital. Banks that do not generate sufficient capital internally may require external sources of capital. Large, independent institutions may seek additional funding from the capital markets. Smaller institutions may rely on its parent holding company, a principal shareholder, or a control group to provide additional funds, or may rely on the issuance of new capital instruments to existing or new investors. Current shareholders may resist efforts to issue

new capital instruments because of the diluting effect of the new capital. In deciding whether to raise additional capital in this manner, shareholders should weigh the dilution against the possibility that, without the additional funds, the institution may fail.

Under the FDI Act, a depository institution holding company is required to serve as a source of strength to its subsidiary depository institutions. A holding company can fulfill this obligation by having enough liquidity to inject funds into the depository institution or by having access to the same sources of additional capital, that is, current or existing shareholders, as outlined above.

Financial Considerations

Financial information can be found on Schedule RC-R of the Report of Condition and Income (Call Report) for banks; however, risks may not always be reflected in the current financial condition. Therefore, examiners should not rely solely on an institution’s current financial condition when determining capital adequacy and should assess management’s ability to identify, measure, monitor, and control all material risks that may affect capital. Examiners should evaluate a bank’s capital levels and ratios in view of the bank’s overall financial condition, including the following areas:

Asset quality. Examiners’ supervisory assessment on a bank’s capital adequacy may differ from conclusions based solely from the level of a bank’s risk-based capital ratio. Generally, the main reason for this difference is the evaluation of asset quality. An examiner’s assessment a bank’s capital adequacy takes into account examination findings, particularly the severity of problem and classified assets and investment or loan portfolio concentrations as well as the adequacy of the bank’s allowance for loan and lease losses or adjusted allowance for credit losses.

Balance-sheet composition. A bank whose earning assets are not diversified or whose credit culture is more risk-tolerant is generally expected to operate with higher capital levels than a

23. For the complete text of the policy statement on the payment of cash dividends by state member banks and BHCs that are experiencing financial difficulties see the Bank Holding Company Supervision Manual and Attachment B to SR-09-4.
24. For more information, see the “Dividends” section of this manual.
25. For more information, see the “Supervision of Subsidiaries” section in the Bank Holding Company Supervision Manual.
similar-sized institution with well-diversified, less-risky investments.

**Earnings.** A bank’s earnings performance should enable it to fund growth, compete in the marketplace, and support its risk profile. An adequately capitalized, growing bank should have a consistent pattern of capital augmentation by earnings retention. Poor earnings can have a negative effect on bank’s capital adequacy in two ways. First, any losses absorbed by capital reduce the ability of the remaining capital to absorb future losses. Second, the impact of losses on capital is magnified by the fact that a bank generating losses is incapable of replenishing its capital accounts internally.

**Funds management.** A bank with undue levels of interest-rate risk may need to strengthen its capital positions, even though it may meet the minimum risk-based capital standards. The adequacy and effectiveness of an institution’s interest-rate risk management process and the level of its interest-rate risk exposure are critical factors in the examiners’ evaluation of an institution’s sensitivity to changes in interest rates and capital adequacy. Examiners consider how a bank manages its interest-rate exposures. A bank’s funds management systems should be commensurate with its earnings and capital levels, complexity, business model, risk profile, and scope of operations. If a bank determines that its core earnings and capital are insufficient to support its level of interest-rate risk, a bank should take steps to mitigate its risk exposure or increase its capital, or take both steps. See SR-10-1, “Interagency Advisory on Interest Rate Risk,” for more information.

**Off-balance-sheet items and activities.** Once funded, off-balance-sheet items become subject to the same capital requirements as on-balance-sheet items. A bank’s capital levels should be sufficient to support the quality and quantity of assets that would result from a significant portion of these items being funded within a short time.

**Inadequate Allowance for Loan and Lease Losses or Adjusted Allowances for Credit Losses.** An inadequate ALLL or AAACL will require an additional charge to current income. Any charge to current income will reduce the amount of earnings available to supplement tier 1 capital. Because the amount of the ALLL or AAACL that can be included in tier 2 capital is limited to 1.25 percent of gross risk-weighted assets, an additional provision may increase the ALLL or AAACL level above this limit, thereby resulting in the excess portion being excluded from tier 2 capital.

**Ineligible Collateral and Guarantees.** Regulation Q recognizes only limited types of collateral and guarantees. Other types of collateral and guarantees may support a bank’s asset mix, particularly within its loan portfolio. Such collateral or guarantees may serve to improve substantially the overall quality of a loan portfolio and other credit exposures and should be considered by examiners in their overall assessment of a bank’s capital adequacy.

**Market Value of Bank Stock.** Examiners should review trends in the market price of a bank’s stock and whether its stock is trading at a reasonable multiple of earnings or a reasonable percentage (or multiple) of book value. A bank’s low stock price may merely be an indication that it is undervalued, or it may be indicative of regional or industry-wide problems. However, a low-valued stock may also indicate that investors lack confidence in the institution; such lack of support could impair the bank’s ability to raise additional capital in the capital markets.

**Other Real Estate Reserves.** Other real estate reserves, whether considered general or specific reserves, are not recognized as a component of regulatory capital. However, examiners should consider these reserves when classifying an other real estate (ORE) asset as a Loss. Examiners should consider the existence of any general ORE reserves when determining the amount of the loss on an ORE asset. To the extent that ORE reserves adequately cover the risks inherent in the ORE portfolio as a whole, including any individual ORE assets classified Loss, there would not be a deduction from common equity tier 1 capital. The ORE Loss in excess of ORE reserves should be deducted from common equity tier 1 capital under assets other than held-for-investment loans and leases classified loss.

**Unrealized Asset Values.** Banks often have assets on their books that are carried at significant discounts below current market values. The excess of the market value over the book value (historical cost or acquisition value) of assets
such as investment securities or banking premises may represent capital to the bank. These unrealized asset values are not included in the risk-based capital calculation; however, examiners should consider these assets when assessing a bank’s capital adequacy. Further, as part of this assessment, examiners should consider the nature of the asset, the reasonableness of its valuation, its marketability, and the likelihood of its sale.

RATING THE CAPITAL FACTOR FOR STATE MEMBER BANKS

As stated in the Uniform Financial Institutions Rating System27 for commercial banks and thrifts, a financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. Examiners should consider the effect of credit, market, and other risks on the institution’s financial condition when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution’s activities will determine the extent to which it may be necessary for an institution to maintain capital at levels above required regulatory minimums in order to reflect properly the potentially adverse consequences that these risks may have on the institution’s capital.

Examiners rate an institution’s capital adequacy based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the institution’s overall financial condition.
- The ability of management to address emerging needs for additional capital.
- The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses, adjusted allowances for credit losses, and other valuation reserves.
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
- Risk exposure represented by off-balance-sheet activities.
- The quality and strength of earnings, and the reasonableness of dividends.
- Prospects and plans for growth as well as the institution’s past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

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Ratings

1. A rating of “1” indicates a strong capital level relative to the institution’s risk profile.
2. A rating of “2” indicates a satisfactory capital level relative to the financial institution’s risk profile.
3. A rating of “3” indicates a less than satisfactory level of capital that does not fully support the institution’s risk profile. The rating indicates a need for improvement, even if the institution’s capital level exceeds minimum regulatory and statutory requirements.
4. A rating of “4” indicates a deficient level of capital. In light of the institution’s risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.
5. A rating of “5” indicates a critically deficient level of capital such that the institution’s viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.
1. To determine the adequacy of capital.
2. To determine compliance with the risk-based and leverage capital adequacy rules.
3. To determine if the policies, practices, and procedures with regard to the capital adequacy rules are adequate.
4. To determine if the bank’s officers and employees are operating in conformity with the Board’s established capital adequacy rules.
5. To evaluate the propriety and consistency of the bank’s present and planned level of capitalization in light of the risk-based and leverage capital rules as well as existing conditions and future plans.
6. To initiate corrective action when policies, procedures, or capital are deficient.
1. Determine whether bank policies and practices promote capital preservation and address future capital needs. Consider the following:
   • The strategic plan and its underlying assumptions, projected asset growth, dividend plans, asset quality, income, liquidity, funds management, deposit structure, parent-company relationship, contingent liabilities, expansion plans, competition, and economic conditions;
   • Findings from interviews with management regarding the strategic planning process (including any potential issues due to a change in prompt corrective action (PCA) designation);
   • Internal risk-monitoring policies and procedures;
   • The availability of additional capital sources (such as funding provided by insiders, external sources, or additional debt at the parent level); and
   • The permissibility of current or planned components of capital to qualify as Common Equity Tier 1 Capital or Additional Tier 1 Capital.

2. Review historical and planned dividend payout ratios and other planned capital reductions, including reductions subject to legal restrictions and prior Board approval. For planned capital stock retirements, ensure management requested prior regulatory approval. Also, determine whether management evaluated the impact of the capital conservation buffer, including reductions subject to legal restrictions and prior Board approval.

3. Determine whether entries to capital accounts are appropriate and properly authorized.

4. Assess controls over off-balance sheet items (Schedule RC-L) and their overall impact to sufficiency of capital levels and needs.

5. Review board and management’s procedures to prevent, detect, and respond to policy exceptions that may affect capital.

6. Determine whether the audit function verifies the accuracy of the capital accounts and regulatory reports; assesses the appropriateness, accuracy, and timeliness of reports produced for the board and executive management; and evaluates the reasonableness of capital planning.

7. Determine whether audits or independent reviews include an assessment of bank policies and procedures as well as regulatory requirements related to capital issues.

8. Determine whether Board and management reports provide sufficient, timely, and accurate information.

9. Review the accuracy of the bank’s calculation of Common Equity Tier 1 Capital, Additional Tier 1, and Tier 2 Capital. Reviewing the bank’s calculations may involve some of the following procedures:
   • Review Call Report Schedule RC-R and supporting documentation.
   • Determine whether the bank has chosen to opt-out of the inclusion of accumulated other comprehensive income.
   • Review applicable deductions and adjustments for each tier of capital, including phase-in and phase-out provisions (refer to 217.22 for capital adjustments and deduction rules and 217.300 for transition provisions).
   • Consider whether the bank has non-qualifying capital instruments or non-qualifying minority interests subject to phase-out (refer to 217.20 for criteria for capital instruments for each tier of capital, 217.21 for minority interest rules, and 217.300 for transition provisions).

10. Review the accuracy of the bank’s calculation of risk-weighted assets reported on Schedule RC-R, Part II. Reviewing the bank’s calculations may involve some of the following procedures:
    • Determine whether risk weights for most assets conform to applicable requirements (Part 217.32).
    • As applicable, review risk weights for other categories of exposures, such as
      — Off-balance sheet exposures (Part 217.33),
      — Over-the-counter derivative contracts (Part 217.34),
      — Cleared transactions (Part 217.35),
      — Guarantees and credit derivatives (Part 217.35),
      — Collateralized transactions (Part 217.37)
11. Review the bank’s capital ratios under the revised PCA standards. If the bank is less than well capitalized under the revised standards (or appears that it could become less than well capitalized due to the phase-in of deductions or other aspects of the new capital rules), consider whether the bank has a reasonable strategy to meet the fully phased-in requirements over the transition period.

12. Review the bank’s capital conservation buffer and the appropriateness of any distributions and discretionary bonus payments.

13. Determine whether earnings performance enables the bank to fund growth, compete in the marketplace, and support the overall risk profile. Consider the level and trend of equity capital in relation to asset levels, quality, and growth rates.
   • Assess the impact of current and projected provisions to the allowance for loan and lease losses (ALLL) on capital retention and growth.
   • Review whether the bank is relying on core earnings or non-recurring income.
   • Determine whether dividends are excessive compared to current earnings. (Consider applicable state and federal guidance.)

14. Determine whether the existing capital level is adequate for the bank’s risk profile when considering the following items:
   • The adequacy of capital-management policies and controls;
   • The level, type, and trend of adversely classified assets;
   • The adequacy of the ALLL;
   • The volume and trends of charged-off loans and recoveries;
   • The balance sheet structure and liquidity needs;
   • The level, type, and trend of concentrations;
   • The vulnerability of assets and liabilities to adverse events;
   • The volume of unrealized gains or losses on available-for-sale securities;
   • The degree of interest rate risk exposure assumed by the bank;
   • The reasonableness of booked, future tax benefits;
   • The accounting treatment and valuation of intangible assets;
   • The extent of contingent liabilities associated with trusts or other activities;
   • Dividend/repayment requirements for government capital programs (for example the Troubled Asset Relief Program or Small Business Lending Fund);
   • The extent of any other liabilities not shown on the bank’s books, including contingent liabilities;
   • The existence of pending litigation against the bank (and its subsidiaries) and the potential and estimated loss exposure;
   • The volume and risk characteristics of new business initiatives and higher risk investment or lending strategies (for example, subprime lending or mobile banking), or involvement in nontraditional activities such as non-deposit products, insurance sales, or discount brokerage services;
   • The extent to which higher-risk loans or investments may require additional capital under the revised regulatory capital rules’ risk-weights (for example, high-volatility commercial real estate loans, equity exposures, or certain structured or securitized investments);
   • Compliance with state and federal capital level requirements; and
   • The level of operational and reputational risk.

15. Assess the adequacy of management’s actions to correct criticisms related to capital in previous examination reports and recent internal or external audits.

16. Evaluate the effectiveness of management’s internal processes and risk management practices at preparing for and reacting to changes in economic, industry, and regulatory environments, including the ability to assess capital needs under a range of reasonably anticipated adverse events.

17. Determine whether management effectively identifies and manages
   • the institution’s overall risk profile,
   • factors that may change the institution’s risk profile, and
   • how a change in the risk profile will affect the sufficiency of capital levels.
18. Determine whether management effectively identifies and manages any changes to regulatory capital rules by
   • evaluating its prospective capital position pursuant to the revised rule(s); and
   • ensuring that the board is aware of these changes.
   • adopting ways to measure capital based on any revisions to the capital rule(s); and
Dividends

Dividends are distributions of earnings to owners. Dividends can influence an investor’s willingness to purchase corporate stock since the investor generally expects reasonable investment returns. Although dividends usually are declared and paid in either cash or stock, occasionally they are used to distribute real or personal property. Dividend payments may reduce capital in some banks to the point of supervisory concern. As a result, certain statutory limitations apply to the payment of dividends.

If a bank is a subsidiary of a bank holding company, examiners should also be aware of a bank’s parent company cash-flow needs. In addition to the payment of dividends, the parent company may need cash for debt service or to fund its operations. Parent company debt generally is primarily serviced through dividend payments by the subsidiary bank. When establishing dividend levels from a bank subsidiary, the parent company should not set a dividend rate that will place undue pressure on the bank’s ability to maintain an adequate level of capital.

Declaration of a dividend requires formal action by the board of directors to designate the medium of payment, dividend rate, shareholder record date, and date of payment. Dividends may be declared at the discretion of the board. The bank should conduct appropriate capital planning and due diligence to ensure the dividend payments will not place undue pressure on the bank’s current and future capital levels.

Dividends are recorded by debiting “retained earnings” and crediting “dividends declared not yet payable,” which is to be reported in other liabilities. Upon payment of the dividend, “dividends declared not yet payable” is debited for the amount of the cash dividend with an offsetting credit, normally in an equal amount, to “dividend checks outstanding” which is reportable in the “demand deposits” category of the bank’s deposit liabilities. For more information, see the Call Report Instructions.

SUPERVISORY GUIDANCE ON DIVIDENDS

In addition to statutory limitations of the payment of dividends, on November 14, 1985, the Federal Reserve Board issued a policy statement on the payment of dividends by state member banks and bank holding companies. The complete statement is available in the Federal Reserve Regulatory Service at 4–877, section 2020.5, “Intercompany Transactions (Dividends),” in the Bank Holding Company Supervision Manual. A summary of the 1985 policy statement on the payment of dividends is provided below.

In 2009, the Federal Reserve issued SR letter 09–4, “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies,” which provides guidance on the declaration and payment of dividends, capital redemptions, and capital repurchases by bank holding companies in the context of their capital planning processes. While SR-09-4 applies to bank holding companies, its principles are also broadly relevant to state member banks. In 2015, the Federal Reserve issued SR letter 15–18; “Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms,” and SR letter 15–19, “Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms.” While SR-15-18 and SR-15-19 generally apply to the largest bank holding companies, the principles of the 1985 Policy Statement on the Payment of Dividends are incorporated into these SR letters. Specifically, firms should have comprehensive policies on dividend payments that clearly articulate their objectives and approaches for maintaining a strong capital position and achieving the principles of the policy statement.

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1. Other payments not called dividends may also be distributions of earnings to owners. These distributions or “constructive dividends” may be termed fees, bonuses, or other payments. Constructive dividends are distinct from legitimate fees, bonuses, and other payments, which are reasonable, adequately documented, and for valuable goods and services provided to the bank. Constructive dividends may create a potential tax liability and indicate control issues or insider self-dealing, and they may portend shareholder lawsuits against insiders, board members, and the bank.

2. At a minimum, board of directors minutes approving declaration and payment of a dividend should include three components: (1) the “as of” date to identify shareholders of record to receive the dividend (date of record), (2) an amount or description of the dividend, and (3) identification of the date on which the dividend payment is to take place (date of payment). There may also be additional legal requirements that should be documented, depending on state laws and the nature of the dividend.
SUMMARY OF POLICY STATEMENT ON PAYMENT OF DIVIDENDS

Adequate capital is critical to the health of individual banking organizations and to the safety and stability of the banking system. A major determinant of a financial institution’s capital adequacy is earnings strength and whether earnings are retained or paid to shareholders as dividends. Dividends are a primary way that banking organizations provide return to shareholders on their investment.

During profitable periods, dividends represent a return of a portion of a banking organization’s net earnings to its shareholders. During less profitable periods, dividend rates are often reduced or sometimes eliminated. The payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization’s capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization’s problems.

Therefore, as a matter of prudent banking it is generally only appropriate for a bank or bank holding company to continue its existing rate of cash dividends on common stock only if

- the organization’s net income available to common shareholders over the past year has been sufficient to fully fund the dividends; and
- the prospective rate of earnings retention appears consistent with the organization’s capital needs, asset quality, and overall financial condition.

Any banking organization whose cash dividends are inconsistent with either of these criteria should seriously consider reducing or eliminating its dividends. Such an action will help conserve the organization’s capital base and help it weather a period of adversity.

It is generally inconsistent with prudent banking practices for a banking organization that is experiencing financial problems or that has inadequate capital to borrow to pay dividends; this would result in increased leverage at the very time the organization needs to reduce its debt or conserve its capital. Similarly, the payment of dividends based solely or largely on gains resulting from unusual or nonrecurring events may be imprudent. Unusual or nonrecurring events may include the sale of assets, the effects of accounting changes, the postponement of large expenses to future periods, or negative provisions to the allowance for loan and lease losses.

CAPITAL CONSERVATION BUFFER

The Board’s Regulation Q (12 CFR 217) limits capital distributions and discretionary bonus payments for banking organizations that do not hold a specified amount of common equity tier 1 capital in addition to the amount of regulatory capital necessary to meet the minimum risk-based capital requirements (capital conservation buffer). A banking organization’s capital conservation buffer must be greater than 2.5 percent of its total risk-weighted assets in order to avoid limitations on capital distributions and discretionary bonus payments.3

If a banking organization’s capital conservation buffer falls below 2.5 percent, its maximum payout amount for capital distributions and discretionary payments declines to a set percentage of eligible retained income based on the size of the bank’s buffer. Table 1 reflects the maximum payout ratio for the capital conservation buffer.

The types of payments subject to the restrictions include dividends, share buybacks, discretionary payments on capital instruments, and discretionary bonus payments. It is important to note that the Board may require a Board-regulated institution to hold an amount of regulatory capital greater than otherwise required if the Board determines that the banking organization’s capital requirements are not commensurate with its credit, market, operational, or other risks. For more information, see this manual’s section entitled, “Assessment of Capital Adequacy,” and 12 CFR 217.11.

3. A banking organization may have a capital conservation buffer greater than 2.5 percent under certain circumstances. For example, a global systemically important bank holding company (G-SIB) is subject to a G-SIB surcharge that expands the capital conservation buffer applicable to the company. G-SIBs are also subject to a buffer over the supplementary leverage ratio that imposes limits very similar to the capital conservation buffer."
Three major federal statutory limitations govern the payment of dividends by banks. These limitations, included in sections 1831o, 56, and 60 of title 12 of the United States Code (12 U.S.C. 1831o, 56, and 60), apply to cash dividends and non-stock property dividends. Common stock dividends (dividends payable in common stock to all the common shareholders of the bank) may be paid regardless of these statutory limitations since such dividends do not reduce the bank’s capital. In addition, the examiner needs to be aware of any state laws governing dividend payments.

### Prompt Corrective Action

Section 1831o, also referred to as the prompt-corrective-action (PCA) provision, was adopted in 1991 as part of the Federal Deposit Insurance Corporation Improvement Act. Section 1831o applies to all insured depository institutions, including state member banks, and is implemented through section 208.40 of Regulation H. This regulatory section prohibits the payment of dividends when a bank is deemed to be undercapitalized or when the payment of the dividend would make the bank undercapitalized in accordance with the PCA framework. An organization that is undercapitalized for purposes of PCA must cease paying dividends for as long as it is deemed to be undercapitalized. Once earnings have begun to improve and an adequate capital position has been restored, dividend payments may resume in accordance with federal and state statutory limitations and guidelines.

### Sections 56 and 60

Sections 56 and 60 (sections 5204 and 5199 of the Revised Statutes) were first adopted as part of the National Bank Act more than a century ago. Although these sections were made applicable to national banks, they also apply to state member banks under the provisions of section 9 of the Federal Reserve Act. These sections are implemented through section 208.5 of Regulation H.

Under section 56, prior regulatory and shareholder approval must be obtained if the dividend would exceed the bank’s undivided profits (retained earnings), as reportable in its Reports of Condition and Income (Call Reports). In addition, the bank may include amounts contained in its surplus account, if the amounts reflect transfers made in prior periods of undivided profits and if regulatory approval for the transfer back to undivided profits is obtained.

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4. State-chartered banks that are not members of the Federal Reserve System (state nonmember banks) are not subject to sections 56 and 60. However, they may be subject to similar dividend restrictions under state law.

5. Although the language of section 56 could imply that a dividend cannot be declared in excess of the limit even if regulatory approval were obtained, a “return of capital” to shareholders is allowed under section 59 if the bank obtains prior regulatory approval and the approval of at least two-thirds of each class of shareholders.
Under section 60, prior regulatory approval to declare a dividend must be obtained if the total of all dividends declared during the calendar year, including the proposed dividend, exceeds the (1) sum of the net income earned during the year-to-date and (2) the retained net income of the prior two calendar years as reported in the bank’s Call Reports. In determining this limitation, any dividends declared on common or preferred stock during the period and any required transfers to surplus or a fund for the retirement of any preferred stock must be deducted from net earnings to determine the net income and retained net income.\(^6\)

The statutory limitations are tied to the declaration date of the dividend because, at that time, shareholders expect the dividends will be paid, a liability is recorded, and the bank’s capital is reduced. If the bank’s board of directors wishes to declare a dividend between Call Report dates, the earnings or losses incurred since the last Call Report date should be considered in the calculation. Thus, if a bank’s dividend-paying capacity might be limited under sections 56 or 60, the bank should ensure it has sufficient capacity to declare the dividend by maintaining sufficient documentation to substantiate its earnings or losses on an accrual basis for the period since the last Call Report date.

**REQUEST FOR REGULATORY APPROVAL**

When regulatory approval is required for dividend payments under section 56 or 60, the request should be submitted to the appropriate Federal Reserve Bank. In section 265.11(e)(4) of the Rules Regarding Delegation of Authority, the Reserve Banks have been delegated authority to permit a state member bank to declare dividends in excess of section 60 limits. Before approving the request, the Reserve Bank should consider if the proposed dividend is consistent with the bank’s capital needs, asset quality, strength of management, and overall financial condition.

If applicable, examiners should verify that prior approval was obtained from the Federal Reserve Bank, and, if required, at least two-thirds of each class of stockholders before the dividend was paid. Violations of law or safety and soundness concerns arising from nonconformance with the Federal Reserve Board’s policy statement should be discussed with bank management and noted in the examination report.

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\(^6\) In rare circumstances when the surplus of a state member bank is less than what applicable state law requires the bank to maintain relative to its capital stock account, the bank may be required to transfer amounts from its undivided profits account to surplus. This may arise, for example, because some states require surplus to equal or exceed 100 percent of the capital stock account. Such required transfers would reduce the section 60 calculation.
Dividends
Examination Procedures
Effective date April 2020

Section 3025.3

1. Evaluate the bank’s dividend policies (which may be in the overall capital planning policy) and determine whether they provide appropriate guidance for managing the bank’s dividends. Consider whether policies
• are consistent with the board’s risk appetite;
• are reviewed and approved by the board at appropriate intervals;
• require maintenance of adequate records and documentation of the stock accounts and shareholders, as applicable;
• provide for compliance with applicable laws and regulations;
• clearly and completely articulate the bank’s objectives for maintaining a satisfactory capital position, including restricting dividends and other capital distributions when the bank does not, or may not, meet required capital levels or internal targets;
• include appropriate targets, limits, or floors for dividends;
• incorporate measures to ensure that sufficient capital remains after the payment of dividends to support the bank’s business plans, growth, and business goals as stated in the bank’s strategic or capital plans;
• address the authorization of capital account and dividend transactions;
• require adequate documentation of capital transactions with affiliates or related organizations;
• address the employment of an independent stock registrar or stock transfer agent (e.g., review policies for third-party vendors), if applicable; and
• address the selection and use of a third-party dividend paying agent, if applicable.

2. Determine whether policies establish limits on dividends and issuances of capital instruments, redemptions, or repurchases, and delineate prudent actions to be taken if the limits are exceeded. Consider whether policies
• include sufficient standards for detecting and preventing activities that could materially affect the capital accounts, dividends, and capital adequacy;
• provide guidelines for setting dividends at appropriate levels relative to the bank’s financial position; and
• include processes for reporting and remediating breaches of dividend.

3. Review any relevant work performed by internal or external auditors. If any deficiencies were noted in the latest internal or external auditor reports, determine if appropriate corrective action has been taken.

4. Review board or risk committee minutes for discussions regarding internal risk assessment activities that management uses to supervise dividends.

5. Determine whether board and senior management receives information about emerging issues in a timely manner.

6. Review board or risk committee minutes for discussions regarding internal risk assessment activities that management uses to supervise dividends.

7. Review historical and planned dividend payout ratios and other planned capital reductions. For planned capital stock retirements, ensure management requested prior regulatory approval. Also, determine whether management evaluated the impact of the capital conservation buffer.

8. Determine whether dividends are excessive compared to current earnings.

9. Determine whether the bank complies with applicable laws and regulations related to dividends.

10.a. If dividends were declared since the last examination, complete the dividend limitations worksheets to determine whether the bank was in compliance with the following sections of the U.S. Revised Statutes, as they are interpreted by section 208.5 of Regulation H:
• section 5199 (12 USC 60), which establishes a restriction based on the current and prior two years’ retained net income, as adjusted for required transfers to surplus or transfers to a fund for the retirement of any preferred stock. Table 1 on the next page may be used for the calculation.

• section 5204 (12 USC 56), which establishes a restriction on dividends based on the bank’s retained earnings (undivided profits), as adjusted for any surplus transferred, with prior regulatory approval, as needed, back to undivided profits and the excess, if any, of credit losses or other losses derived from extensions of credit over the allowance for loan and lease losses (ALLL).\(^1\)

1. Although section 56 seems to indicate that a bank should deduct its credit losses from its undivided profits, this adjustment is not generally necessary. Under generally accepted accounting principles, banks reserve for bad debts in the ALLL, which reduces the bank’s undivided profits. Banks should deduct only the credit losses in excess of the bank’s ALLL, and such excess should rarely occur. The second part of table 1 illustrates the section 56 dividend-limitation calculation.

b. For the calculations in table 1, determine whether the dividend exceeded the section 56 or 60 limits and, if so, whether the dividend received prior approval. Dividends declared in excess of the section 56 limitation must receive prior Federal Reserve approval and approval by at least two-thirds of the shares of each class of stock outstanding, pursuant to 12 USC 59. Dividends declared in excess of the section 60 limitation must receive prior Federal Reserve approval.
### Table 1—Dividend-Limitation Computations

*References to schedules in this table are to the schedules in the Consolidated Reports of Condition and Income (bank Call Reports).*

#### Section 60 Computation

<table>
<thead>
<tr>
<th>Year</th>
<th>20__</th>
<th>20__</th>
<th>20__</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(schedule RI, item 12)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Required transfers to surplus under state law (generally zero) or transfers to a fund for the retirement of any preferred stock</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common and preferred stock dividends declared (schedule RI-A, item 8 + item 9)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained net profits available for dividends before adjustments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjustments for dividends in excess of income (if any)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained net profits available for dividends after adjustments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. Any excess may be attributed to the prior two years by first applying the excess to the earlier year, and then the immediately preceding year, net of any previous-year adjustments. See section 208.5 of Regulation H for further guidance.

2. This is the section 60 limitation.

#### Section 56 Computation

<table>
<thead>
<tr>
<th>Year</th>
<th>20__</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings (undivided profits) (schedule RC, item 26a)</td>
<td></td>
</tr>
<tr>
<td>Add:</td>
<td></td>
</tr>
<tr>
<td>Surplus in excess of state regulatory requirements that was earned and is transferred, with prior regulatory approval, back to undivided profits</td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Loan losses or other losses derived from extensions of credit that are in excess of the allowance for loan and lease losses</td>
<td></td>
</tr>
<tr>
<td>Section 56 limitation</td>
<td></td>
</tr>
</tbody>
</table>
Overview of Asset-Backed Commercial Paper Programs  
Effective date October 2018  
Section 3030.1

INTRODUCTION

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.

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 obligations 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 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. Commercial paper maturities range from 1 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.

THE LOSS WATERFALL

The loss waterfall diagram (on the next page) 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 be either 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 struc-
tured (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 asset-backed securities (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 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 in the form of either (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. 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-wide credit enhancement even when the legal documents state that the program-wide credit 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. 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. 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 pur-

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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.
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.
chased 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. Program-wide liquidity also provides liquidity in the event of a short-term disruption in the commercial paper market. 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.
INTRODUCTION

In 1991, Congress enacted a regulatory framework to address the problems associated with troubled insured depository institutions with the intent of minimizing the long-term cost to the Deposit Insurance Fund. This legislation led to the enactment of the prompt-corrective-action (PCA) statute, which is contained in the Federal Deposit Insurance Corporation Improvement Act of 1991, and added section 38 to the Federal Deposit Insurance Act (FDIA), as amended (12 U.S.C. 1831o).

FDIA section 38 requires regulators to administer timely corrective action to insured depository institutions when their capital position declines or is deemed to have declined below certain threshold levels as a result of an unsafe or unsound condition or practice. The PCA framework specifies mandatory actions that regulators must take as well as discretionary actions they must consider taking.

In order to implement PCA as it applies to state member banks (bank), the Federal Reserve Board added subpart D to its Regulation H (12 CFR 208.40 to 208.45). While in practice this discussion refers to the Federal Reserve Board, actions taken within the PCA framework involve consultation between the Reserve Bank staff and the Federal Reserve Board staff. Therefore, inquiries relating to PCA should be directed to appropriate Federal Reserve Board staff. The Federal Reserve Board also added subpart E to its Rules of Practice for Hearings (12 CFR 263.80 to 263.85) to establish procedures for the issuance of notices, directives, and other actions authorized under FDIA section 38 and Regulation H.

PCA uses capital ratios to trigger specific actions that are designed to restore a bank to financial health. One of the primary sources of the financial information for these ratios is the Consolidated Reports of Condition and Income (Call Report). This gives added importance to the review of a bank’s records for accuracy during an examination. Under the PCA statute a bank is assigned to one of five capital categories: (1) well capitalized, (2) adequately capitalized, (3) undercapitalized, (4) significantly undercapitalized, and (5) critically undercapitalized. See the table at the end of this section for a summary of framework definitions. As a bank is placed in progressively lower capital categories, FDIA provides for increasingly stringent corrective provisions. The Federal Reserve has maintained the general structure of the existing PCA framework while incorporating increased minimum capital requirements, including:

- In 2013, when the Federal Reserve Board implemented higher minimum capital requirements and adjusted ratios in four of the five capital categories of the PCA framework.¹
- In 2019, the Federal Reserve Board, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (FDIC) adopted a rule that provides for a simple measure of capital adequacy for certain community banking organizations, consistent with section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act. This 2019 rule established the community bank leverage ratio (CBLR) framework. A depository institution or depository institution holding company that qualifies and opts into the CBLR framework (12 CFR 217.12) will be considered to have met the “well capitalized” ratio requirements for PCA purposes. For more information on the CBLR framework, see 84 Federal Register 61,797 (November 13, 2019) and this manual’s section on “Assessment of Capital Adequacy.”

PCA CATEGORIES

PCA uses the total risk-based capital measure, tier 1 risk-based capital measure, common equity tier 1 risk-based capital measure, leverage ratio, and tangible equity to total assets ratio for assigning banks to the five capital categories.²

¹. See the Board’s Regulation Q (12 CFR 217) and 78 Fed. Reg. 62,018 (October 11, 2013).
². The total risk-based capital ratio is defined as the ratio of qualifying total capital to standardized total risk-weighted assets; the tier 1 capital ratio is the ratio of tier 1 capital to standardized total risk-weighted assets; the common equity tier 1 capital ratio is defined as the ratio of common equity tier 1 capital to standardized total risk-weighted assets; and the tier 1 leverage ratio is the ratio of tier 1 capital to total average consolidated assets (the Federal Reserve may use
These ratios are defined in the Federal Reserve Board’s Regulation Q, “Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks.”

A bank’s PCA category is based upon capital ratios derived from items such as the Call Report, examination report, bank applications, and reports filed by the bank under banking or securities laws as well as other sources. In general, a bank is deemed to be notified of its PCA category based upon

- the Call Report: as of the date that a bank is required to file its Call Report,
- the Federal Reserve Board or state examination report: as of the third day following the date on the Federal Reserve or state transmitted letter to a bank that accompanies the examination report, and
- other information: the bank’s receipt of written notice by the Federal Reserve Board that the bank’s capital category has changed.

The Federal Reserve’s notification to a bank of its PCA category is important since any bank assigned to the undercapitalized, significantly undercapitalized, or critically undercapitalized categories is subject to certain mandatory provisions, immediately upon notification. These mandatory and discretionary provisions are described in detail later.

The following are descriptions of the five PCA capital categories:

1. **Well capitalized.** The bank has a total risk-based capital ratio of 10.0 percent or greater, a tier 1 risk-based capital ratio of 8.0 percent or greater, a common equity tier 1 risk-based capital ratio of 6.5 percent or greater; and a leverage ratio of 5.0 percent or greater, and the bank is not subject to an order, written agreement, capital directive, or PCA directive to meet and maintain a specific capital level for any capital measure. A qualifying community banking organization, as defined in 12 CFR 217.12, which has elected to use the CBLR framework is considered to have met the capital ratio requirements for the well capitalized capital category. In order to qualify for the CBLR framework, a depository institutions or depository institution holding company must have (among other things) a leverage ratio greater than 9.0 percent and less than $10 billion in average total consolidated assets. For the complete list of qualifying criteria for the CBLR framework, see 12 CFR 217.12.

2. **Adequately capitalized.** The bank has a total risk-based capital ratio of 8.0 percent or greater, a tier 1 risk-based capital ratio of 6.0 percent or greater, a common equity tier 1 risk-based capital ratio of 4.5 percent or greater, and a leverage ratio of 4.0 percent or greater (or a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMELS rating system in its most recent report of examination), and the bank is not experiencing or anticipating significant growth and does not meet the definition of a “well-capitalized” bank.

3. **Undercapitalized.** The bank has a total risk-based capital ratio that is less than 8.0 percent, a tier 1 risk-based capital ratio that is less than 6.0 percent, a common equity tier 1 risk-based capital ratio that is less than 4.5 percent or a leverage ratio that is less than 4.0 percent (or a leverage ratio that is less than 3.0 percent if the bank is rated composite 1 under the CAMELS rating system in its most recent report of examination), and the bank is not experiencing or anticipating significant growth.

4. **Significantly undercapitalized.** The bank has a total risk-based capital ratio of less than 6.0 percent, a tier 1 risk-based capital ratio of less than 4.5 percent, and does not meet the definition of a “well-capitalized” bank.

5. **Critically undercapitalized.** The bank has a total risk-based capital ratio of less than 4.0 percent, a tier 1 risk-based capital ratio of less than 3.0 percent, and meets the definition of a “critically undercapitalized” bank.

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In March 2020, section 4012 of the Coronavirus Aid, Relief, and Economic Security Act provided the agencies with the authority to grant banks with temporary regulatory relief for certain provisions of the CBLR framework. The agencies issued an interim final rule to adopt these temporary regulatory changes. See 85 Fed. Reg. 22,924 (April 23, 2020) for the details and timeframe for this regulatory relief.

For an advanced approaches bank or bank that is a Category III Board-regulated institution (as defined in 12 CFR 217.2), a supplementary leverage ratio of 3.0 percent or greater.

For an advanced approaches bank or bank that is a Category III Board-regulated institution, a supplementary leverage ratio of less than 3.0 percent.
4. **Significantly undercapitalized.** The bank has a total risk-based capital ratio that is less than 6.0 percent, a tier 1 risk-based capital ratio that is less than 4.0 percent, a common equity tier 1 risk-based capital ratio that is less than 3 percent or a leverage ratio that is less than 3.0 percent.

5. **Critically undercapitalized.** The bank has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.¹

**EXAMINATION CONSIDERATIONS**

If a bank is deemed undercapitalized, significantly undercapitalized, or critically undercapitalized, examiners should discuss the PCA provisions with the institution’s management during the examination. Additionally, examiners should caution a bank when its capital ratios approach those found in the undercapitalized category to ensure that proposed dividend or management fee payments do not cause the bank to violate the statute. Any PCA-related comments should be noted in the examination report. The comments should be limited to the mandatory provisions of the statute, reflect the immediacy of these provisions, and clearly indicate that the bank’s receipt of the report of examination serves as notification that the bank is subject to PCA provisions.

**Capital Adequacy Page**

In the report of examination for most community banks, the PCA capital ratios appear on the “Capital Adequacy” section of the “Analysis of Financial Factors” page and are generally calculated using the bank’s most recent Call Report. In situations where the impact of examination findings (for example, loan-loss-reserve adjustments or other losses) cause the bank to fall into a lower PCA category, the narrative portion of this examination report page should explicitly state the adjusted PCA ratios and reconcile the adjustments that examiners made.

**RECLASSIFICATION**

In the majority of cases, a bank’s PCA category is defined by its capital ratios indicated in the preceding definitions. The finding of an unsafe or unsound condition or practice, however, may lead the Federal Reserve to reclassify a bank’s PCA category to the next lower PCA category than the bank would otherwise qualify for based solely on its capital ratios.² In these circumstances, the Federal Reserve Board may

- reclassify a well-capitalized bank to the adequately capitalized category,
- require an adequately capitalized bank to comply with one or more supervisory actions specified by PCA as though the bank is an undercapitalized bank,
- impose one or more supervisory actions on an undercapitalized bank that would be authorized for a significantly undercapitalized bank.

While the latter two actions do not strictly represent reclassifications from one category to another, they are nonetheless collectively referred to as “reclassifications” for PCA purposes.

FDIA section 38 does not automatically subject a bank that has been reclassified to the next lower capital category to the mandatory restrictions of the lower category. These mandatory restrictions can only be imposed through the use of a PCA directive, and only those mandatory and discretionary provisions deemed appropriate by the Federal Reserve Board will be imposed. A bank can only be reclassified to the next lower capital category and cannot be classified as critically undercapitalized on any basis other than its tangible equity ratio.

The reclassification of a bank for PCA purposes may affect the bank’s ability to accept brokered deposits. If a well- or adequately capitalized bank is reclassified, the bank must obtain an FDIC waiver to accept brokered deposits, regardless of its actual capital level. (This manual’s Deposit Accounts section contains a detailed discussion on the capital requirements relating to brokered deposit activities.)

An “unsafe or unsound condition” is not defined in the PCA statute and assessment and, therefore is left to the discretion of the Federal Reserve Board. Banks determined by the Federal Reserve to be in an unsafe or unsound condition based on the results of the most recent report of examination or Call Report will be reclassified. Examiners should consider a bank for reclassification if the imposition of the available PCA provisions would assist the bank to

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¹ The Federal Reserve may, at its discretion, “calculate total assets using a bank’s period-end assets rather than quarterly average assets.” 12 CFR 208.41(m).

² See 12 CFR 208.43(c).
return to a safe or sound condition or the bank to institute safe or sound practices. In addition, an “unsafe or unsound practice” is defined as a less-than-satisfactory rating for any of the AMELS ratings for the Asset quality, Management, Earnings, Liquidity or Sensitivity to market risk components of the CAMELS rating in the bank’s most recent examination report and that has not been corrected since the examination.

The Federal Reserve Board recognizes that certain banks that are candidates for reclassification may have taken favorable actions that are consistent with the purposes of PCA. In these cases, reclassification may not be warranted if

- the bank has raised or can demonstrate current efforts to raise enough capital to become and remain well capitalized for the foreseeable future, and
- the bank has attempted to be in substantial compliance with all provisions of any outstanding informal or formal enforcement action, management is addressing existing problems and is considered satisfactory, and the bank’s condition is stable and shows signs of improvement.

Where reclassification is determined to be appropriate, the Federal Reserve Board will provide the bank with a written notice specifying its intention to reclassify the bank, along with an explanation of the reasons for the downgrade. The date of the reclassification and the required PCA provisions can be made effective either at a specified future date or, under certain circumstances, immediately, at the discretion of the Federal Reserve Board. A bank is entitled to appeal a reclassification, which includes the opportunity for an informal hearing, following the receipt of a written notice. The appeal and hearing procedures are set out in subpart H of the Federal Reserve Board’s Rules of Practice for Hearings in section 263.203 (12 CFR 263.203).

PCA PROVISIONS

Provisions Applicable to All Banks

Two provisions are applicable to all banks (including well capitalized and adequately capitalized banks):

1. A bank may not pay dividends or make any other capital distributions that would leave it undercapitalized.
2. A bank may not pay a management fee to a controlling person if, after paying the fee, the bank would be undercapitalized. Management fees subject to this restriction include those relating to supervisory, executive, managerial, or policymaking functions, other than compensation to an individual in the individual’s capacity as an officer or employee of the bank. This does not include fees relating to nonmanagerial services provided by the controlling person, such as data processing, trust activities, mortgage services, audit and accounting, property management, or similar services.

Restrictions on Advertising

The Federal Reserve Board prohibits banks from advertising its PCA capital category. However, banks are not restricted from advertising their capital levels or financial condition.

Provisions Applicable to Undercapitalized Banks

A bank categorized as undercapitalized is subject to several mandatory provisions that become effective upon the Federal Reserve Board notifying the bank. Under the mandatory provisions, an undercapitalized bank

- must cease paying dividends.

10. FDIA section 38 explains that the purpose of PCA “is to resolve the problems of insured depository institutions at the least possible long-term loss to the Deposit Insurance Fund.” 12 U.S.C. 1831o(a)(1).

11. FDIA section 38 (12 U.S.C. 1831o(d)(1)(B)) requires that the Federal Reserve Board consult with the FDIC before approving a capital distribution under this section. Section 38 also contains a limited exception to the restrictions on capital distributions for certain types of stock redemptions that (1) the Federal Reserve Board has approved, (2) are made in connection with an equivalent issue of additional shares or obligations, and (3) will improve the bank’s financial condition. See 12 U.S.C. 1831o(d)(1)(B). The Federal Reserve Board may also impose restrictions on capital distributions on any company that controls a significantly undercapitalized bank.

12. See 12 CFR 208.40(d).
• is prohibited from paying management fees to a controlling person (see the previous subsection for exceptions).
• is subject to increased monitoring by the Federal Reserve Board and periodic review of the bank’s efforts to restore its capital.
• must file and implement a capital restoration plan generally within 45 days. Undercapitalized banks that fail to submit or implement a capital restoration plan are also subject to the provisions applicable to significantly undercapitalized banks.
• may acquire interest in a company, open any new branch offices, or engage in a new line of business only if the following three requirements are met:
  — the Federal Reserve Board has accepted its capital restoration plan,
  — any increase in total assets is consistent with the capital restoration plan, and
  — the bank’s ratio of tangible equity to assets increases during the calendar quarter at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time.

In addition to the mandatory provisions, a number of discretionary provisions may be imposed by the Federal Reserve Board on an undercapitalized bank. These include:
• requiring recapitalization by doing one or more of the following:
  — That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
  — That the aforementioned additional capital be voting shares.
  — That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.
• restricting transactions between the bank and its affiliates.
• restricting the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.
• restricting the bank’s asset growth or requiring the bank to reduce its total assets.
• requiring the bank or any of its subsidiaries to terminate, reduce, or alter any activity determined by the Federal Reserve Board to pose excessive risk to the bank.
• ordering a new election of the board of directors, dismissing certain senior executive officers, or hiring new officers.
• prohibiting the acceptance, renewal, and roll-over of deposits from correspondent depository institutions.
• prohibiting any bank holding company that controls the bank from making any capital distribution, including but not limited to dividend payment, without the prior approval of the Federal Reserve Board.
• requiring the bank to divest or liquidate any subsidiary that is in danger of becoming insolvent and that poses a significant risk to the bank, or is likely to cause significant dissipation of its assets or earnings.
• requiring any company that controls the bank to divest or liquidate any affiliate of the bank (other than another insured depository institution) if the Federal Reserve Board determines that the affiliate is in danger of becoming insolvent and poses a significant risk to the bank, or is likely to cause significant dissipation of the bank’s assets or earnings.
• requiring the bank to take any other action that would more effectively carry out the purpose of PCA than the above actions.

Provisions Applicable to Significantly Undercapitalized Banks

The mandatory restrictions applicable to undercapitalized banks also apply to banks that are significantly undercapitalized. In addition, a significantly undercapitalized bank is restricted in paying bonuses or raises to senior executive officers of the bank unless it receives prior written approval from the Federal Reserve Board. If a bank fails to submit an acceptable capital restoration plan, however, no such bonuses or raises may be paid until an acceptable plan has been submitted.

The Federal Reserve Board must take the following actions unless it is determined that these actions would not further the purpose of PCA (resolution at the least possible long-term loss to the Deposit Insurance Fund):

• Require one or more of the following:
  — That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
  — That the aforementioned additional capital be voting shares.
— That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.

• Restrict the bank’s transactions with affiliates.

• Restrict the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.

In addition to these mandatory provisions, the Federal Reserve Board will impose one or more of the discretionary provisions for undercapitalized banks on a significantly undercapitalized bank. Moreover, other measures (including the provisions for critically undercapitalized banks) may be required if the Federal Reserve Board determines that such actions will advance the purpose of PCA. 13

Provisions Applicable to Critically Undercapitalized Banks

A critically undercapitalized bank must be placed in conservatorship (with the concurrence of the FDIC) or receivership within 90 days, unless the Federal Reserve Board and the FDIC concur that other action would better achieve the purposes of PCA. The statute also addresses requirements in deferring the placing of a critically undercapitalized bank in conservatorship or receivership. 14

A bank must be placed in receivership if it continues to be critically undercapitalized on average 15 during the fourth calendar quarter following the period that it initially became critically undercapitalized, unless the Federal Reserve Board, with the FDIC’s concurrence, determines that:

• the bank has a positive net worth.

• the bank has been in substantial compliance with its capital restoration plan since the date of the plan’s approval.

• the bank is profitable or has a sustainable upward trend in earnings.

• the bank is reducing its ratio of nonperforming loans to total loans.

• the chair of the Federal Reserve Board and the chair of the FDIC both certify that the bank is viable and not expected to fail.

Beginning 60 days after becoming critically undercapitalized, critically undercapitalized banks are also prohibited from making any payment of principal or interest on subordinated debt issued by the bank without the prior approval of the FDIC. Unpaid interest, however, may continue to accrue on subordinated debt under the terms of the debt instrument. The FDIC is also required, at a minimum, to prohibit a critically undercapitalized bank from doing any of the following without the prior written approval of the FDIC:

• entering into any material transaction not in the usual course of business. Such activities include any investment, expansion, acquisition, sale of assets, or other similar action where the bank would have to notify the Federal Reserve.

• extending credit for any highly leveraged transaction.

• amending the bank’s charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order.

• making any material change in accounting methods.

• engaging in any covered transaction under section 23A(b) of the Federal Reserve Act.

• paying excessive compensation or bonuses.

• paying interest on new or renewed liabilities that would increase the bank’s weighted average cost of funds to a level significantly exceeding the prevailing rate of interest paid on insured deposits in the bank’s normal market area.

Capital Restoration Plans

A bank that is undercapitalized, significantly undercapitalized, or critically undercapitalized must submit an acceptable capital restoration plan to the Federal Reserve Board. This plan must be submitted in writing and specify—

• the steps the bank will take to become adequately capitalized;

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15. The average is determined by adding the sum of the total tangible equity ratio at the close of business on each day during the quarter and dividing that sum by the number of business days in that quarter.
• the levels of capital the bank expects to attain each year that the plan is in effect;
• how the bank will comply with the restrictions and requirements imposed on it under FDIA section 38;
• the types and levels of activities in which the bank will engage; and
• any other information required by the Federal Reserve Board.

The Federal Reserve Board cannot accept a capital restoration plan unless the plan
• contains the information required in the preceding five points;
• is based on realistic assumptions and is likely to succeed in restoring the bank’s capital;
• would not appreciably increase the risk (including credit risk, interest-rate risk, and other types of risk) to which the bank is exposed; and
• contains a guarantee from each company that controls the bank, specifying that the bank will comply with the plan until it has been adequately capitalized on average during each of four consecutive calendar quarters, and each company has provided appropriate assurances of performance. (See the subsequent subsection, “Capital Restoration Plan Guarantee,” for additional information.)

Submission and Review of Capital Plans

The Federal Reserve Board has established rules regarding a uniform schedule for the filing and review of capital restoration plans. These rules require a bank to submit a capital restoration plan within 45 days after the bank has received notice, or has been deemed to have been notified, that it is undercapitalized, significantly undercapitalized, or critically undercapitalized. The Federal Reserve Board may change this period in individual cases, provided it notifies the bank that a different schedule has been adopted. The Federal Reserve Board must also

• review each capital restoration plan within 60 days of the bank’s submission of the plan unless it extends the review time;
• provide written notice to the bank about whether it has approved or rejected the capital plan; and
• provide a copy of each acceptable capital restoration plan, and amendments thereto, to the FDIC within 45 days of accepting the plan.

There are two cases where a capital restoration plan may not be required:

1. When a bank has capital ratios consistent with those corresponding to the adequately capitalized category but, due to unsafe or unsound conditions or practices, has been reclassified to the undercapitalized category. (If the Federal Reserve requires a plan solely due to such a reclassification, the plan should specify the steps the bank will take to correct the unsafe or unsound condition or practice.)

2. When a bank’s capital category changes, but the bank is already operating under a capital restoration plan accepted by the Federal Reserve.

The Federal Reserve Board will examine the circumstances of each of the above cases to determine whether a bank must submit a revised plan.

Capital Restoration Plan Guarantee

The Federal Reserve Board cannot approve a capital restoration plan unless each company that controls the bank has guaranteed the bank’s compliance with the plan and has provided reasonable assurances of performance. The Federal Reserve Board will consider on a case-by-case basis the appropriate type of guarantee for multi-tier holding companies, or parent holding companies that are shell companies or that have limited resources. A guarantee that is backed by a contractual pledge of resources from a parent company may satisfy the requirements of FDIA section 38, particularly in situations involving the ownership of an insured bank by a foreign holding company through a wholly owned domestic shell holding. In other situations, a third-party guarantee made by a party with adequate financial resources may be satisfactory.

PCA also contains several provisions that clarify the capital restoration plan guarantee:

• Limitation on liability. The aggregate amount of liability under the guarantee for all companies that control a specific bank is limited to the lesser of (1) an amount equal to 5 percent of the bank’s total assets, or (2) the amount
necessary to restore the relevant capital ratios of the bank to the level required for the bank to be categorized as adequately capitalized.

- **Limitation on duration.** The guarantee and limit on liability expires after the Federal Reserve Board notifies the bank that it has remained adequately capitalized for each of the previous four consecutive calendar quarters.

- **Collection of guarantee.** Each company that controls a given bank is jointly and severally liable for the guarantee.

- **Failure to provide a guarantee.** A bank will be treated as if it had not submitted an acceptable capital restoration plan if its capital plan does not contain the required guarantee.

- **Failure to perform under a guarantee.** A bank will be treated as if it failed to implement the capital restoration plan if any company that controls the bank fails to perform its guarantee.

**Failure to Submit an Acceptable Capital Plan**

An undercapitalized bank that fails to submit or implement, in any material respect, an acceptable capital restoration plan within the required period is subject to the same provisions applicable to a bank that is significantly undercapitalized. If a bank’s capital restoration plan is rejected by the Federal Reserve Board, the bank is required to submit a new capital plan within the time period specified by the Federal Reserve Board. During the period following notice of the rejection, and before Federal Reserve Board approval of a new or revised capital plan, the bank is treated in the same manner as a significantly undercapitalized bank.

**ISSUANCE OF PCA DIRECTIVES**

The Federal Reserve Board must provide a bank, or company controlling a bank (company), a written notice of proposed action under FDIA section 38 (referred to as a directive), unless the circumstances of a particular case indicate that immediate action is necessary to serve the purpose of PCA. These directives are issued for reasons such as reclassifying a bank and implementing discretionary provisions, the latter of which includes the dismissal of directors or senior executive officers.

A notice of intent to issue a directive should include

- a statement of the bank’s capital measures and levels;
- a description of the restrictions, prohibitions, or affirmative actions that the Federal Reserve Board proposes to impose or require;
- the proposed date when such restrictions or prohibitions would be effective or the proposed date for completion of such affirmative actions; and
- the date by which the bank or company subject to the directive may file with the Federal Reserve Board a written response to the notice.

When a directive becomes effective at a future date, the Federal Reserve Board must provide the bank or company an opportunity to appeal the directive before taking final action. This requires the bank to submit information relevant to the decision within the time period set by the Federal Reserve Board, which must be at least 14 calendar days from the date of the notice, unless the Federal Reserve Board determines that a shorter period is appropriate in light of the financial condition of the bank or other relevant circumstances.

In the case of a directive that is immediately effective upon notification of the bank, the Federal Reserve Board’s rules provide an opportunity for the bank or company to seek an expedited modification or rescission of the directive. A bank or company that appeals a directive effective immediately is required to file a written appeal within 14 days of receiving the notice, and the Federal Reserve Board will consider the appeal within 60 days of receiving it. During the period that the appeal is under review the directive remains in effect, unless the Federal Reserve Board stays the effectiveness of the directive.

**Dismissal of Directors or Senior Executive Officers**

The Federal Reserve Board’s rules establish a special procedure permitting an opportunity for senior executive officers and directors dismissed from a bank as a result of a PCA directive to petition the Federal Reserve Board for reinstatement.
A director or senior executive officer who is required to be dismissed in compliance with a Federal Reserve Board directive may have the dismissal reviewed by filing, within 10 days, a request for reinstatement with the Federal Reserve Board. The respondent will also be given the opportunity to submit written materials in support of the petition and to appear at an informal hearing before representatives of the Federal Reserve Board. Unless otherwise ordered by the Federal Reserve Board, the dismissal remains in effect while a request for reinstatement is pending. No later than 60 calendar days after the date the record is closed or the date of the response in a case where no hearing was requested, the Federal Reserve Board shall grant or deny the request for reinstatement and notify the respondent of the Federal Reserve Board’s decision. The date for the hearing and for the ultimate decision follows the same timeframe as that indicated for the appeals process in the preceding paragraph.

Enforcement of Directives

PCA directives may be enforced in the federal courts, and may also subject any bank, company, or institution-affiliated party that violates the directive to civil money penalties or other enforcement actions. The failure of a bank to implement a capital restoration plan, or the failure of a company having control of a state member bank to fulfill a guarantee that the company has given in connection with a capital plan accepted by the Federal Reserve Board, could subject the bank or company or any of their institution-affiliated parties to a civil money penalty assessment.
TABLE 1—SUMMARY OF SPECIFICATIONS OF CAPITAL CATEGORIES FOR PROMPT CORRECTIVE ACTION FOR INSTITUTIONS NOT SUBJECT TO THE COMMUNITY BANK LEVERAGE RATIO FRAMEWORK

<table>
<thead>
<tr>
<th>Capital Category</th>
<th>Total Risk-Based Capital Measure</th>
<th>Tier 1 RBC Measure</th>
<th>Common Equity Tier 1 RBC Measure</th>
<th>Leverage Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well Capitalized</td>
<td>10% or more and 8% or more and</td>
<td>6.5% or more and</td>
<td>5% or more* and</td>
<td></td>
</tr>
<tr>
<td>Adequately Capitalized</td>
<td>8% or more and 6% or more and</td>
<td>4.5% or more and</td>
<td>4% or more**</td>
<td></td>
</tr>
<tr>
<td>Under-capitalized</td>
<td>less than 8% or less than 6% or</td>
<td>less than 4.5% or</td>
<td>less than 4%**</td>
<td></td>
</tr>
<tr>
<td>Significantly Under-capitalized</td>
<td>less than 6% or less than 4% or</td>
<td>less than 3% or</td>
<td>less than 3%</td>
<td></td>
</tr>
<tr>
<td>Critically Under-capitalized</td>
<td></td>
<td>tangible equity to total assets ratio of 2% or less</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* For a bank that is a subsidiary of a G-SIB, a supplementary leverage ratio of 6.0 percent or more.
** For an advanced approaches bank or bank that is a Category III Board-regulated institution, a supplementary leverage ratio of 3.0 percent or more.
Prompt Corrective Action
Examination Objectives
Effective date November 2020

Section 3035.2

1. To assess whether prompt-corrective-action (PCA) provisions are necessary.
2. To assess whether the policies, practices, and procedures are in place to ensure compliance with PCA mandatory and discretionary provisions.
3. To verify that undercapitalized, significantly undercapitalized, and critically undercapitalized banks have effective capital restoration plans that comply with PCA.
Prompt Corrective Action
Examination Procedures

**Section 3035.3**

1. During on-site examinations, validate the state member bank’s capital levels, risk-weighted assets, and capital ratios in compliance with primary capital provisions of section 38 of the Federal Deposit Insurance Act (FDIA) and the Federal Reserve’s respective capital adequacy rules. (See this manual’s section on the Assessment of Capital Adequacy and 12 CFR 217.) Verify that the bank’s
   a. capital instruments are appropriate for inclusion in common equity tier 1, tier 1, or tier 2 capital.
   b. assets were properly risk-weighted and that the appropriate credit equivalent measure (for example, the credit-conversion factors, credit-rating factors) were assigned for the bank’s off-balance-sheet assets or transactions.
2. When a state member bank is considered undercapitalized, significantly undercapitalized, or critically undercapitalized, discuss with the bank’s management the prompt corrective action restrictions under FDIA section 38 and the Board’s Regulation H (12 CFR 208, subpart D).
3. When a state member bank is operating with an amount of consolidated capital that is near the undercapitalized levels, caution the board of directors and senior management about their ensuring that any proposed dividend or management fee payments do not cause the bank to violate FDIA section 38.
4. When the impact of the bank’s examination findings (for example, loan-loss-reserve adjustments or other losses) will cause the bank to fall into a lower prompt-corrective-action category, explicitly state in the narrative portion of the capital examination report page the adjusted prompt-corrective-action capital ratios with a clear account of the adjustments that were made to the quarter-end or period-end ratios.
5. Include in the appropriate report page of the state member bank examination report any comments regarding the applicability of FDIA section 38 and Regulation H pertaining to prompt corrective action. With regard to prompt corrective action, limit the comments to the mandatory restrictions of the statute and the immediacy of those provisions. State that the receipt of the state member bank examination report serves as notification that the bank is subject to prompt corrective action.