

# Commercial Bank Examination Manual

## Supplement 47—April 2017

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### Summary of Changes

#### *Foreword*

Minor revisions were made to the Foreword to provide updated information on how to order the Commercial Bank Examination Manual and how to access it on the Federal Reserve Board's website at <https://www.federalreserve.gov/publications/supmanual.htm>.

#### *Preface*

The Preface was removed from the manual. Previously, the Preface contained chronological information regarding the changing legislative and regulatory environment of the banking industry. This section was removed because the information was duplicative and readers can locate more comprehensive discussions on developments in the banking industry in the specific manual sections.

#### *Section 1000.1*

This section, "Examination Strategy and Risk-Focused Examinations," was revised to reflect references to an interim final rule that amended Regulation H to raise the total asset threshold for which an insured depository institution can be eligible for an 18-month examination cycle rather than a 12-month examination cycle from less than \$500 million to less than \$1 billion. The interim final rule was made effective February 29, 2016, with the Board approving the final rule in December 2016. The final rule adopted the interim final rule without change. See SR-17-2, "Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations." Modifications were made to the alternate year examination program to reflect the guidance transmitted in SR-17-2. In addition, minor grammatical edits were made to several pages in this section.

#### *Section 1015.1*

This section, "Conflict-of-Interest Rules for Examiners," was revised to include changes resulting from the issuance of SR-16-16 / CA-16-7, "Special Post-Employment Restriction for Senior Examiners." The letter was issued to announce an amendment to the Board's rule on Post-Employment Restrictions for Senior Examiners (12 CFR 264a), which expands the definition of "senior examiner." This amendment was developed to promote consistency in post employment ethics rules across the Federal Reserve System and to address the risk associated with individuals leaving the Federal Reserve for employment with a regulated entity.

#### *Section 2080.1*

This section, "Commercial and Industrial Loans," was revised to remove a subsection titled "Loan Sampling and Coverage Requirements" because the guidance was outdated and no longer reflected the supervisory approach to loan review at large state member banks. Subsequent sections in the manual describe loan sampling and coverage expectations for state member banks with less than \$50 billion in total assets.

#### *Section 6010.1*

This section, "Other Types of Examinations," was revised to provide updated terminology and high-level guidance on the Federal Reserve's supervisory responsibilities of information technology, trust activities, transfer agent activities, securities dealer activities, and consumer compliance at state member banks. The section was also updated to include a reference to the December 2016 final rule that amended Regulation H and Regulation K, which raised the total asset threshold for an insured depository institution to be eligible for an 18-month examination cycle. See SR-17-2 for more information. This section now includes a reference table with a partial list of key guidance and resources that apply to the supervision of the entities and activities described in this section.

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**FILING INSTRUCTIONS**

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Cover page (3 pages)	Cover page (4 pages)
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# Commercial Bank Examination Manual

## Supplement 46—October 2016

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### Summary of Changes

#### *Section 1000.1*

This section, “Examination Strategy and Risk-Focused Examinations,” was amended to include changes resulting from the June 8, 2016, issuance of SR-16-11, “Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$50 Billion.” The supervisory guidance applies to assessing risk-management practices at state member banks, bank holding companies, and savings and loan holding companies (including insurance and commercial savings and loan holding companies) with less than \$50 billion in total consolidated assets and foreign banking organizations with combined U.S. assets of less than \$50 billion. When SR-16-11 was issued, SR-95-51, “Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies,” became applicable only to state member banks and bank holding companies with \$50 billion or more in total assets. Both SR-95-51 and SR-16-11 are included in this manual section. (Refer to SR-16-11 and its attachment.)

#### *Section 4020.1*

This section, “Liquidity Risk,” is revised to include “Interagency Guidance on Funds Transfer Pricing Related to Funding and Contingent Liquidity Risks,” issued March 1, 2016. The guidance (refer to appendix 3 of this section) was issued to address weaknesses observed in some large financial institutions’ funds transfer pricing (FTP) practices related to funding risk (including interest rate and liquidity components) and contingent liquidity risk. (Refer to SR-16-3 and also to the March 1, 2016, attachment to the interagency guidance, “Illustrative Funds Transfer Pricing Methodologies.”) FTP is an important tool for managing a firm’s balance sheet structure and measuring risk-adjusted profitability. By allocating funding and contingent liquidity risks to business lines, products, and activities within a firm, FTP influences the volume and terms of new business and ongoing portfolio composition. If done effectively, FTP promotes more resilient, sustainable business models. (Refer to SR-16-3 and its attachments.)

### FILING INSTRUCTIONS

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### Summary of Changes

#### *Section 1000.1*

This section, “Examination Strategy and Risk-Focused Examinations,” is revised to include a discussion of a rule that amended Regulation H to raise the statutory maximum total asset threshold for a state member bank (SMB) to be eligible for the expanded 18-month examination cycle (as opposed to 12 months) from less than \$500 million to less than \$1 billion in total assets. A SMB with less than \$1 billion in total assets may be eligible for the 18-month examination cycle if it satisfies certain qualifying criteria. (Refer to SR-16-6 and its attachment.)

#### *Sections 1020.1, 1020.2, 1020.3*

Section 1020.1 on the “Federal Reserve System Bank Surveillance Program” discusses “Enhancements to the Federal Reserve System’s Surveillance Program.” (Refer to SR-15-16, and its attachment.) The Surveillance Program uses algorithms that are incorporated into regular monitoring systems to identify aspects of state member banks’ financial condition and performance that may warrant possible supervisory attention. In addition to the Watch List and its use of the Supervision and Regulation Statistical Assessment of Bank Risk (SR-SABR) early warning model, the algorithms’ main components are the Outlier List, the State Member Bank Monitoring Screen, and the Intercompany Transactions Exception List. The algorithms use data gathered on the Call report, other financial regulatory reports, as well as examination data to identify institutions exhibiting financial deterioration, weaknesses, an increased or changing risk profile, or deviations from supervisory expectations. Also, the monitoring systems may identify complex operations, can be used to detect novelties or departures from expected performance or risk patterns, and they identify the institutions that fail the key screening criteria. The surveillance results can be used in pre-examination planning to schedule and determine the type of risk-focused examination to be performed, to assess significant risk exposures, outlooks, and possible non-compliance con-

cerns, and to calibrate supervisory and examination resources to risk. The Surveillance Program’s objectives, phases, structure, and maintenance are discussed in the section along with additional information on the metrics, procedures, and write-up requirements. The examination objectives, section 1020.2, and the examination procedures, section 1020.3, are revised.

#### *Section 2088.1*

This new section, “Off-site Review of Loan Files,” announces to state member banks (SMBs) with less than \$50 billion in total assets, that they have the option to have Federal Reserve examiners review loan files off site during full-scope or target examinations. Federal Reserve examiners may conduct an off-site loan review provided the SMB has communicated its willingness to participate in the program and is able to appropriately image and send its legible and sufficiently comprehensive loan information to the Federal Reserve Bank in a secure manner. (Refer to SR-16-8.)

#### *Section 4128.1*

This section, “Private Banking,” is revised to provide supplemental information about customer identification program (CIP) requirements found in section 326 of the USA PATRIOT Act (referred to as the “CIP” rule). The CIP rule requires a bank to obtain sufficient information to form a reasonable belief regarding the identity of each “customer.” The definition of an “account” is provided, and also information for determining if an “account” has been created. Under the CIP rule, a person that opens a new account is deemed to be a “customer.” (Refer to SR-16-7 and its interagency attachment.)

#### *Section 6010.1*

This section is revised under the subheading, “U. S. Activities of Foreign Banking Organizations,” to include amendments made to section 10(d) of the Federal Deposit Insurance Act (FDI Act) that permit a longer cycle to conduct examinations of insured depository institutions

based on certain qualifying criteria – at least once every 18 months instead of 12 months. The Board approved on February 29, 2016, a rule that amended Regulation K, which resulted from the FDI Act amendments. Regulation K governs the on-site examination cycle for Board supervised U.S. branches and agencies of foreign banks. A U. S. branch or agency of a

foreign bank with less than \$1 billion in total assets may be eligible for an 18-month, instead of a 12-month, on-site examination cycle if it received, at its most recent examination, a composite condition rating of “1” or “2” under the supervisory rating system and if it satisfies other qualifying criteria. (Refer to SR-16-6 and its attachment.)

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### Summary of Changes

#### *Section 1000.1*

This section, “Examination Strategy and Risk-Focused Examinations,” includes revised guidance within its subsection on “Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank.” The guidance further explains the Federal Reserve’s criteria for waiving or conducting pre-membership safety-and-soundness and consumer compliance examinations of insured depository institutions that are either (1) seeking to become state member banks; or (2) merging with another institution where a state member bank would be the surviving entity. Further, the guidance clarifies the eligibility criteria for when the Federal Reserve may waive a pre-membership or pre-merger examination. (Refer to SR-15-11/CA-15-9.)

#### *Section 2080.1*

This section, “Commercial and Industrial Loans,” has been revised within the subsection, “Loan Sampling and Coverage Requirements.” References have been changed from SR-02-19 to the manual’s section 2082.1, and SR-14-7 to section 2086.1. Also, the limitation for using statistical loan sampling at banks was revised from less than \$1 billion to \$10 billion or less. (See section 2082.1.)

#### *Section 2082.1*

This section, “Loan-Sampling Program for Community Banks,” includes revised procedures governing the use of statistical sampling in the review of commercial and industrial loans and commercial real estate loans during safety and soundness examinations of community banking organizations (CBOs). The “Core” bucket and its sub-buckets have been amended to provide greater flexibility to risk focus the loan review process. Instead of the loan review “Core” bucket requirements of the ten largest, ten large

problem, five insider, and five new borrower exposures, the revised procedures require that the “Core” bucket loan review consist of up to a total of 25 borrowers. The “Core” bucket is to consist of appropriate representation of the largest, largest new, largest problem, and largest insider credits, respectfully, to be determined based on the examiner’s judgment of where the examination should be appropriately risk-focused. The limitation for using statistical loan sampling at banks was revised from less than \$1 billion to \$10 billion or less.

#### *Section 2084.1*

This section, “Loan Sampling Requirements for State Member Bank and Credit-Extending Non-bank Subsidiaries of Banking Organizations with \$10–\$50 Billion in Total Consolidated Assets,” is revised to supplement footnote 1 pertaining to the calculation of a concentration of credit in a loan portfolio or portfolio segment—total risk-based capital refers to tier 1 capital plus the allowance for loan and lease losses. Also, a reference to banking organizations does not include savings and loan holding companies.

#### *Section 2086.1*

This section, “Loan Coverage Examination Requirements for Community State Member Banks with \$10 Billion or Less in Total Consolidated Assets,” is revised to reference section 2082.1 instead of SR-02-19, and to remove a reference to SR-14-7.

#### *Section 5020.1*

This section, “Overall Conclusions Regarding the Condition of the Bank,” is revised to give recognition to the Federal Reserve’s assignment of a risk-management rating during an examination of a state member bank. (See SR-95-51, “Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies.”)

*Section A.5020.1*

This appendix section, “Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve’s Risk Management Rating,” is

revised to give recognition to the Federal Reserve’s assignment of a risk-management rating during an examination of a state member bank. (See SR-95-51.) See the subsection on “Risk-Management Rating,” which follows the subsection on “Sensitivity to Market Risk.”

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# Commercial Bank Examination Manual

## Supplement 43—April 2015

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### Summary of Changes

#### *Section 2040.1*

This section, “Loan Portfolio Management,” has been revised to include interagency “Guidance on Private Student Loans with Graduated Repayment Terms at Origination.” The guidance provides principles that financial institutions should consider in their policies and procedures for originating these loans. Financial institutions should prudently underwrite their private student loans in a manner that is consistent with safe and sound lending practices. Financial institutions should also comply with all applicable federal and state consumer laws and regulations, including the providing of disclosures that clearly communicate the timing and the amount of payments to facilitate borrower understanding of loan terms and features. Refer to SR-15-2/CA-15-1 and its interagency guidance attachment.

#### *Section 3050.1*

This new section, “Dodd-Frank Act Company-Run Stress Testing for Banking Organizations

with Total Consolidated Assets \$10–50 Billion” has been added to the manual. It provides guidance on the supervisory expectations for the Dodd-Frank Wall Street Reform and Consumer Protection Act stress test practices for these respective companies. The section offers additional details about methodologies that should be employed. Refer to SR-14-3 and the 2014 interagency “Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations with Total Consolidated Assets of More Than \$10 Billion but Less than \$50 Billion.” (See 79 Federal Register 14153, March 13, 2014).

*Sections 2000.4, 2080.3, 2130.3, 4052.1, 4060.1, 4060.4, 4063.4, 4128.1, 4128.3, 4140.1, 5020.1, 6000.1, 7030.3, 7050.3, and 8000.1*

These sections have been revised to update Financial Crimes Enforcement Network rule references (e.g., 31 CFR 1010 and 31 CFR 1020 and certain other subsections) pertaining to the Bank Secrecy Act. See also, SR-14-10, “Release of the 2014 Federal Financial Institutions Examination Council’s Bank Secrecy Act/Anti-Money Laundering Examination Manual.”

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# Commercial Bank Examination Manual

## Supplement 42—October 2014

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### Summary of Changes

#### *Section 1020.1*

This section, “Federal Reserve System Bank Watch List and Surveillance Programs,” has been revised to reflect June 5, 2014, enhancements to SR-06-2, February 2, 2006, “Enhancements to the System’s Off-Site Bank Surveillance Program.” The 2014 enhancements indicate that surveillance write-ups for the System’s State Member Bank Watch List banks are not required (in most cases) for institutions with a CAMELS composite rating of 4 or 5 or certain institutions with a CAMELS composite rating of 3. (See the revised discussion under “System Bank Watch List Program” and footnote number 3.)

#### *Section 2080.1*

This section, “Commercial and Industrial Loans,” was modified to incorporate the guidance found in SR-14-4, “Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Banking Organizations with \$10–\$50 Billion in Total Consolidated Assets,” and SR-14-7, “Loan Coverage Requirements for Safety and Soundness Examinations of Community State Member Banks.” The examiner guidance in SR-14-7 may be used for statistical loan sampling for examinations of state member banks having total consolidated assets of \$10 billion or less, provided other qualifying criteria are met. This

provision also applies to the guidance found in section 2082.1.

#### *Section 2082.1*

This section, “Loan-Sampling Program for Certain Community Banks,” was revised to incorporate the changes resulting from the issuances of SR-14-7 and SR-14-4.

#### *Section 2086.1*

This new section, “Loan Coverage Examination Requirements for Community State Member Banks with \$10 Billion or Less in Total Consolidated Assets,” sets forth the loan sampling expectations for Federal Reserve led examinations of community state member banks. It clarifies when statistical sampling is expected to be used and establishes minimum coverage expectations for judgmental samples for full-scope and asset-quality target examinations. Examiners are expected to select for review a sample of loans that is of sufficient size and scope to enable them to reach sound and well-supported conclusions about the quality of, and risk management over, a community state member bank’s lending portfolio. (Refer to SR-14-7, which was subsequently revised on July 29, 2014, to clarify that when calculating a concentration of credit in a loan portfolio or portfolio segment, as described under “Retail Consumer Lending,” a concentration would be more than 25 percent of tier 1 capital plus the allowance for loan and lease losses.)

### FILING INSTRUCTIONS

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#### *Remove*

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# Commercial Bank Examination Manual

## Supplement 41—April 2014

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### Summary of Changes

#### *Section 1005.1*

This section, “Consolidated Supervision Framework for Large Financial Institutions,” is revised to include Appendix A—“Risk Transfer Considerations When Assessing Capital Adequacy.” Refer to SR-13-23, which is additional supplemental guidance to SR-12-17/CA-12-14. It centers on how certain risk transfer transactions affect assessments of capital adequacy at large financial institutions. SR-13-23 provides clarification on supervisory expectations when assessing a firm’s capital adequacy in certain circumstances when the risk-based capital framework may not fully capture the residual risks of a transaction.

This section is also revised to include Appendix B—“Managing Foreign Exchange Settlement Risks for Physically Settled Securities.” See SR-13-24. This guidance sets forth seven principles or “guidelines” for managing foreign exchange transaction settlement risks. The Federal Reserve supports these principles as part of its continuing effort to promote the global financial system’s ability to withstand severe market disruptions. Institutions covered by SR-13-24 should apply the seven guidelines to their foreign exchange activities with the stated clarifications regarding application of the guidance in the United States.

#### *Sections 1010.2, 1010.3, and 1010.4*

These sections on “Internal Control and Audit Function, Oversight, and Outsourcing” have been further revised. The sections consist of the 2003 interagency guidance, “Policy Statement on the Internal Audit Function and Its Outsourcing.” The sections include revised examination objectives, examination procedures, and an internal control questionnaire for both the 2003 guidance and the January 23, 2013, Federal Reserve policy statement that supplements the 2003 interagency guidance. Refer to SR-03-5 and SR-13-1/CA-13-1.

#### *Section 2084.1*

This new section, “Examiner Loan Sampling Requirements for State Member Bank and Credit-Extending Nonbank Subsidiaries of Banking Organizations with \$10–\$50 Billion in Total Consolidated Assets,” sets forth the loan sampling expectations in SR-14-4 that apply to the Federal Reserve’s examination of these state member bank (SMB) and credit-extending nonbank subsidiaries. Examiners will also have the flexibility, depending upon the structure and size of subsidiary SMBs, to utilize the guidance applicable to smaller SMBs when the SMB subsidiary’s total assets are below \$10 billion. This guidance supersedes the examiner loan sampling expectations described in SR-94-13, “Loan Review Requirements for On-site Examinations” (see this manual’s section 2080.1). It clarifies expectations for the assessment of material<sup>1</sup> retail credit portfolios for these institutions.

#### *Section 2090.1*

This section on “Real Estate Loans” was revised to include a brief discussion of the December 13, 2013, “Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans” that was issued to clarify the safety-and-soundness expectations and Community Reinvestment Act considerations for regulated institutions engaged in residential mortgage lending. The Consumer Financial Protection Bureau’s Ability-to-Repay and Qualified Mortgage Standards Rule<sup>2</sup> was issued on January 10, 2013 (effective on January 10, 2014). Institutions may issue qualified mortgages or non-qualified mortgages, based on their business

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1. A loan portfolio or portfolio segment is considered material when the portfolio or segment exceeds 25 percent of total risk-based capital or contributes 25 percent or more to annual revenues.

2. See the Ability-to-Repay and Qualified Mortgage Standards Rule (the Ability-to-Repay Rule) under the Truth in Lending Act (Regulation Z), 78 *Fed. Reg.* 6408 (January 30, 2013), as amended. The Ability-to-Repay Rule requires institutions to make reasonable, good faith determinations that consumers have the ability to repay mortgage loans before extending such loans. In accordance with the rule, a “qualified mortgage” may not have certain features, such as negative amortization, interest-only payments, or certain balloon structures, and must meet limits on points and fees and other underwriting requirements.

strategies and risk appetites. Institutions are to underwrite residential mortgage loans in a prudent fashion and are to address key risk areas in their residential mortgage lending, including loan terms, borrower qualification standards, loan-to-value limits, documentation requirements, and appropriate portfolio and risk-management practices. Refer to SR-13-20/CA-13-23 and its attachment.

### *Sections 2115.2, 2115.3, and 2115.4*

These sections on “Leveraged Lending” have been revised to supplement the March 23, 2013, “Interagency Guidance on Leveraged Lending” with revised examination objectives, examination procedures, and an internal control questionnaire for leveraged lending. The section provides guidance about the risk-management expectations for leveraged loans and examiner guidance for the review of such loans. Refer to SR-13-3 and its attachment.

### *Section 4050.1*

This section, “Transactions Between Member Banks and Their Affiliates,” was revised to reflect the statutory amendments to sections 23A and 23B of the Federal Reserve Act resulting from the enactment of the Dodd-Frank Act. One amendment modifies the definition of an “affiliate” to include an investment fund with respect to which an insured depository institution (IDI) or one of its affiliates is an investment adviser. Also, the definition of “covered transactions” was revised to include securities borrowing,

securities lending, or a derivatives transaction between an IDI and an affiliate to the extent that the transaction causes an IDI or a subsidiary to have a credit exposure with the affiliate. In addition, the Dodd-Frank Act removed the exemption from the 10 percent limit for covered transactions between a bank and any individual financial subsidiary. The retained earnings of a financial subsidiary are to be included as part of the IDI’s investment in the financial subsidiary. The amendments were effective July 21, 2012. (See sections 608 and 609 of the Dodd-Frank Act.)

### *Section 4062.1*

This new section, “Managing Outsourcing Risk,” consists of the December 5, 2013, Federal Reserve “Guidance on Managing Outsourcing Risk” that was issued to assist financial institutions<sup>3</sup> in understanding and managing the risks associated with outsourcing a bank activity to a service provider to perform that activity. The guidance addresses the characteristics, governance, and operational effectiveness of a financial institution’s service provider risk-management program for outsourced activities beyond traditional core bank processing and information technology services. The guidance applies to all service provider relationships regardless of the type of activity that is outsourced. See SR-13-19/CA-13-21 and its attachment.

3. For purposes of this guidance, “financial institutions” refers to state member banks, bank and savings and loan holding companies (including their nonbank subsidiaries), and U.S. operations of foreign banking organizations.

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### Summary of Changes

#### *Section 1000.1*

This section, “Examination Strategy and Risk-Focused Examinations,” is revised to clarify the 60-calendar-days from the close date completion standard and the documentation requirements for examination and inspection reports for community banking organizations with \$10 billion or less in total consolidated assets. Furthermore, for institutions rated composite “3,” “4,” or “5,” Reserve Banks are encouraged to adopt an internal target of 45 calendar days from the close date for sending the reports. The section explains the meaning of “close date” for examinations or inspections. (See SR-13-14.)

#### *Sections 2020.1, 2020.3, and 2020.4*

The section, “Investment Securities and End-User Activities,” has been further revised. The section incorporates the provisions of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This statute requires each federal agency to remove references to, and requirements of reliance on, ratings from nationally recognized statistical rating organizations (external credit ratings) in any regulation issued by the agency. In 2012, the OCC revised its investment security regulations (12 CFR 1) to remove references to the sole reliance on external credit ratings.

Investments in securities and stock by state member banks are required under the Federal Reserve Act (12 USC 335) and Regulation H (12 CFR 208.21) to comply with the OCC investment security regulations. State member banks are to assess a security’s creditworthiness to determine whether the security is investment grade and that the security is not predominantly speculative. (See SR-12-15 and its attached OCC guidance.)

The section also is revised to include the 2013 *Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions* (2013 Securities Classification Guidance). This guidance outlines principles related to the proper classification of securities without relying on ratings issued by external credit rating organizations and applies to state member

banks and in principle to other institutions supervised by the Federal Reserve. The OCC investment security regulations require an institution to monitor investment credit quality through an analytical review of the obligor rather than solely through external credit ratings. Credit quality monitoring provides an opportunity for management to determine whether a security continues to be investment grade or if it has deteriorated and if it requires classification. The 2013 Securities Classification Guidance clarifies the classification standards for securities held by an institution and provides examples that demonstrate when a security is investment grade and when it is not investment grade. (See SR-13-18 and its attachment.)

Also, the section is revised to update or delete statutory and regulatory references and to delete the content of SR letters that have been determined to be inactive. The section’s examination procedures and internal control questionnaire have been revised accordingly.

#### *Section 2103.1*

This section, “Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices,” is revised to clarify procedures for calculating the total commercial real estate (CRE) loan ratio included in the 2006 Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices (2006 CRE Guidance). In March 2008, the Consolidated Reports of Condition and Income (Call Report) were revised, which changed how CRE loan ratios are calculated using the 2006 CRE Guidance. The revised Call Report excludes owner-occupied CRE loans when calculating a bank’s total CRE loan concentration ratio. The section also emphasizes that the supervisory screening criteria for CRE lending activity are not intended to represent hard limits on the bank’s activity, but rather to encourage a dialogue between bank management and supervisors regarding the bank’s level and nature of CRE concentration risk.

#### *Section 6000.1*

The section, “Commercial Bank Report of

Examination,” clarifies the manner in which Federal Reserve examiners communicate supervisory findings to banking organizations and institutions supervised by the Federal Reserve. The guidance discusses the Federal Reserve’s use of standard language for examination/inspection findings with regard to Matters Requiring Immediate Attention (MRIs) and

Matters Requiring Attention (MRAs), reaffirming their definitions, including their use by safety-and-soundness and consumer compliance examiners when communicating supervisory findings to banking organizations. The use of the term, “Observations” is discontinued. (Refer to SR-13-13/CA-13-10 and its attachment.)

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# Commercial Bank Examination Manual

## Supplement 39—April 2013

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### Summary of Changes

#### *Section 1005.1*

This new section, “Consolidated Supervision Framework for Large Financial Institutions,” represents the Federal Reserve’s December 17, 2012, new framework for the consolidated supervision of large financial institutions.<sup>1</sup> The new guidance supersedes the guidance previously found in SR-99-15, “Risk-Focused Supervision of Large Complex Banking Organizations.” The framework strengthens traditional microprudential supervision and regulation to enhance the safety and soundness of individual firms. In addition, it incorporates macroprudential considerations to reduce potential threats to the stability of the financial system and to provide insights into financial market trends. The consolidated supervision framework has two primary objectives:

- *Enhancing resiliency of a firm to lower the probability of its failure or inability to serve as a financial intermediary.*

Each firm is expected to ensure that the consolidated organization (or the combined U.S. operations in the case of foreign banking organizations) and its core business lines can survive under a broad range of internal or external stresses. This requires financial resilience by providing sufficient capital and liquidity, and operational resilience to maintain effective corporate governance, risk management, and recovery planning.

- *Reducing the impact on the financial system and the broader economy in the event of a firm’s failure or material weakness.*

Each firm is expected to ensure the sustainability of its critical operations and banking offices<sup>2</sup> under a broad range of internal or external stresses. This requires, among other things, effective resolution planning that addresses the complexity and the interconnectivity of the firm’s operations.

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1. The framework applies to large financial institutions with consolidated assets of \$50 billion or more.

2. “Banking offices” are defined as U.S. depository institution subsidiaries, as well as the U.S. branches and agencies of foreign banking organizations.

The framework is being implemented in a multi-stage approach. (See SR-12-17/CA-12-14).

#### *Section 1010.1*

This section, “Internal Control and Audit Function, Oversight, and Outsourcing,” is revised to remind state member banks with \$500 million or more in total assets of the key longstanding Federal Deposit Insurance Corporation (FDIC) reporting and filing requirements for insured depository institutions entitled “Annual Independent Audit and Reporting Requirements,” as amended in 2009.<sup>3</sup> The section further explains when an insured depository institution subsidiary may file its audited financial statements at the holding company level.<sup>4</sup> See SR-13-11.

The section includes the March 17, 2003, “Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.” The section has been revised to include the January 23, 2013, “Federal Reserve Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing,” which supplements the 2003 interagency guidance. (See SR-13-1/CA-13-1.)

#### *Section 2020.1*

This revised section, “Investment Securities and End-User Activities,” provides that state member banks are to assess a security’s creditworthiness to determine whether the security is investment grade. Depository institutions can no longer rely solely on reports from external credit reporting agencies when making a determination as to the quality and permissibility of an investment in accordance with the Office of the Comptroller of the Currency’s (OCC’s) rule (12 CFR 1). Securities may qualify for investment by national banks (and thus, state member banks) only if they are determined by the bank to be “investment grade” and are not predominantly speculative in nature. A security meets the “investment grade” test only if the issuer has an adequate capacity to meet its financial

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3. See 12 CFR part 363.

4. For this guidance, the term “holding company” refers to a bank holding company or a savings and loan holding company, as applicable.

commitments under the security for the projected life of the asset or exposure. Based on this definition of “investment grade,” the issuer has an adequate capacity to meet financial commitments if (1) the risk of default by the obligor is low and (2) the full and timely repayment of principal and interest is expected.

While the bank may continue to take into account external credit ratings and assessments as a valuable source of information, it is expected to supplement these ratings with a degree of due diligence processes and additional analyses appropriate for the bank’s risk profile and for the size and complexity of the instrument. There is a detailed discussion of this rule as to what investments can be considered “investment grade” and the investment limitations. (See SR-12-15, November 15, 2012, and the attached OCC guidance.)

### *Section 2022.1*

This new section, “Investing in Securities without Reliance on Ratings of Nationally Recognized Statistical Rating Organizations (NRSROs),” sets forth guidance that informs state member banks, effective January 1, 2013, that they may no longer rely solely on credit ratings issued by NRSROs (i.e., external credit ratings) to determine whether a particular security is an “investment security” that is permissible for investment. See the OCC-issued supplemental guidance (77 *Fed Reg.* 35259 (June 13, 2012)), under the OCC’s rule (12 CFR 1), that states that securities may qualify for investment by national banks only if they are determined by the bank to be “investment grade” and not predominantly speculative in nature.<sup>5</sup> (See SR-12-15 and its attachment, “OCC Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment.”) Institutions may perform due diligence by maintaining and updating internal credit-

rating reports and assessments, which can be supplemented by reports from external credit-rating services.

### *Section 2040.1*

This revised section, “Loan Portfolio Management,” includes amendments to the Federal Reserve Act (FRA) regarding insider lending. The definition of “extension of credit” was revised to include an insured depository institution’s (IDI’s) credit exposure to a person arising from a derivatives transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. See the FRA, section 22(h)(9)(D)(i), as amended by the Dodd-Frank Act, section 614(a), 12 USC 375 b(9).

The Federal Deposit Insurance (FDI) Act also was amended to prohibit the purchase or sale of assets between an IDI and an executive officer, director, or principal shareholder of the IDI and any related interest of such person unless the transaction is on market terms. In addition, if the asset purchase or sale represents more than 10 percent of the IDI’s capital stock and surplus, the transaction must be approved by the majority of the board of directors of the IDI who do not have an interest in the transaction. See the Dodd-Frank Act, section 615(1), codified at 12 USC 1818(2).

### *Section 2115.1*

The “Leveraged Lending” section includes the 2013 updated leveraged lending guidance, which replaced the 2001 “Interagency Guidance on Leveraged Financing.” This guidance describes expectations for the sound risk management of leveraged lending activities, including why institutions need to develop

- transactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these elements of a safe-and-sound loan structure should clearly support a borrower’s capacity to repay and to de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute;

5. Under the Federal Reserve Act (FRA) (12 USC 335) and the Board’s Regulation H (12 CFR 208.21), state member banks are subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as national banks under the National Banking Act (12 USC 24 (Seventh)). When investing in securities, state member banks must comply with the provisions of the National Banking Act and the OCC regulations in 12 CFR 1. In addition to this federal requirement, a state member bank may purchase, sell, underwrite, or hold securities and stock only to the extent permitted under applicable state law.

- a definition of leveraged lending that facilitates consistent application across all business lines;
- well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt;
- a credit limit and concentration framework consistent with the institution's risk appetite;
- sound management information systems that enable management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines;
- strong pipeline management policies and procedures that, among other things, provide for real-time information on exposures and limits, and exceptions to the timing of expected distributions and approved hold levels; and
- guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

This guidance should be consistent with the size and risk profile of an institution's leveraged activities relative to its assets, earnings, liquidity, and capital. Institutions that originate or sponsor leveraged transactions should consider the entire guidance. (See SR-13-3 and its attachment.)

### *Section 5000.1*

This revised section, "Duties and Responsibilities of Directors," updates the content within the subsection on "Compliance with Formal and Informal Supervisory Actions." The section instructs examiners to comment on how the bank accomplished compliance or the problems that have prevented compliance. The guidance notes that it is appropriate for examiners to make all salient negative comments regarding enforcement actions on the Other Matters report page (regular examination report) or the Compliance with Enforcement Actions report page (community bank examination report) to notify bank directors of any remaining enforcement action deficiencies that need correction.

### *Section 5040.1*

This section, "Formal and Informal Supervisory Actions," was revised to discuss further indemnification agreements and payments according to the provisions of section 18(k) of the FDI Act and the FDIC's regulation on indemnification agreements and payments found at 12 CFR part 359. The FDIC's regulations provide that a bank may make or agree to make a reasonable indemnification payment if all of the following conditions are met: (1) the institution's board of directors determines in writing that the institution-affiliated party acted in good faith and in the best interests of the institution; (2) the board of directors determines that the payment will not materially affect the institution's safety and soundness; (3) the payment does not fall within the definition of a prohibited indemnification payment; and (4) the institution-affiliated party agrees in writing to reimburse the institution, to the extent not covered by permissible insurance, for payments made in the event that the institution-affiliated party does not prevail.

The section notes that it is important for examiners to provide adequate support for all recommendations for both formal and informal actions in the examination report and associated workpapers.

### *Section 6003.1*

This section, "Community Bank Examination Report," was revised to reference the use of a letter-format examination report for community banking organizations composite-rated "4" or "5," based on certain conditions. (See section 6005.1 and SR-13-10.)

### *Section 6005.1*

This new section, "Community State Member Banks and Holding Companies Rated Composite '4' or '5,'" discusses the Federal Reserve's adoption of a flexible, letter-format report in lieu of the standard, longer-form report. The report communicates the findings of on-site safety-and-soundness examinations and inspections of community banking organizations<sup>6</sup> that result in

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6. Community banking organizations include state member banks, bank holding companies, and savings and loan holding companies with assets of \$10 billion or less.

composite supervisory ratings of “4” or “5.” Examiners may use the letter-format report provided that all mandatory and any applicable

optional information is included in the report. (See SR-13-10.)

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